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Part one

State of the world economy

Chapter II

The current situation in the world's economies

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Chapter II
The current situation in the world's economies

Observers of current developments in the world economy spent much of 1997 and early 1998 trying to take account of a financial panic that broke through the surface in South-East Asia and spread from one country to another, prompting rescue efforts for the economies of some countries and policy changes in others to better defend against the panic. The panic mainly affected developing countries but some transition economies were also hit and had to take defensive and adjustment measures. It even helped to stop Japan's emerging recovery and, by the end of 1997, Japan was again in outright recession.

The world economy is large and diverse, however, and it has attained a degree of momentum that largely kept up the economic growth rates of the main regions and country groupings in 1997. Indeed, the aggregate output of the transition economies rose for the first time this decade. Per capita output rose in Africa for the second straight year, albeit by hardly enough to register statistically. Growth was strong in Latin America and in most of Asia. In Europe, the pace of growth finally began to gather some steam, providing the margin needed for member countries of the European Union (EU) that sought to reduce their fiscal deficits below the maximum allowed for entry into the single currency area; and in several countries, including the largest in the world, growth continued at a sufficiently strong pace to drop unemployment significantly, while inflation remained almost dormant.

Many of the strengths in the world's economies that were visible in 1997 are expected to continue in 1998. The prospects in North America and in Europe, including the transition economies of Europe, as well as those of Asia, are largely encouraging. However, 1998 will be a more difficult year in much of the developing world, not to mention Japan. Of most concern are the countries in which the financial crisis of 1997 has become the economic recession of 1998. The economic observers who held their breath as they watched the financial developments in 1997 are not yet able to relax and breathe a sigh of relief.

The developed economies

Three clusters of events have characterized the developed economies in 1997 and continue to do so in 1998. First, strong economic growth in North America continues without the emergence of inflationary pressures of note, allowing the increasing absorption of the unemployed into the economy. Second, the concerted and in some cases dramatic efforts in EU to harmonize macroeconomic policy around the standards set by the "Maastricht criteria" have been successful. Thus, on 1 January 1999, monetary union will begin in Europe. The exchange rates of the currencies of the 11 participating countries – Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain – will be irrevocably fixed, the European Central Bank (ECB) will begin operations and the euro will become a fully fledged currency for commercial transactions. In the year 2002, the 11 national currencies will cease to be legal tender. Finally, the developed as well as many developing countries in Asia and the Pacific have had to cope with the 1997 Asian currency crisis. In the case of Japan, this external shock had to be absorbed by an economy that was already seriously weakened. The world's second largest economy will, in essence, stagnate for yet another year in what has been a very disappointing decade.

Economic growth in 1997 and 1998

North America: strength in growth

The growth of the economy of the **United States of America** accelerated from almost 3 per cent in 1996 to almost 4 per cent in 1997. Seven consecutive years of expansion reduced the unemployment rate to 4.6 per cent by the end of 1997, the lowest rate since 1972. Despite robust growth and falling unemployment, inflation dropped to 2.4 per cent (see tables II.1, A.2, A.6 and A.7).

The acceleration in economic activity was led by consumer spending, underpinned by the strong labour market, continuing gains in real incomes and the sustained rise in the net financial wealth of the household sector owing to the rising prices of financial assets. Long-term interest rates have also eased, reflecting declining expectations of future inflation. Lower interest rates also boosted housing investment. After some hesitation in late 1996 and early 1997, corporate investment regained its importance during the rest of 1997 as the principal engine of growth. Investment has risen by 37 per cent in real terms over the past four years. Overall in 1997, stronger domestic demand made up for much of the weakness in the external sector, where the Asian currency crisis lowered demand for United States exports, especially as the year ended.

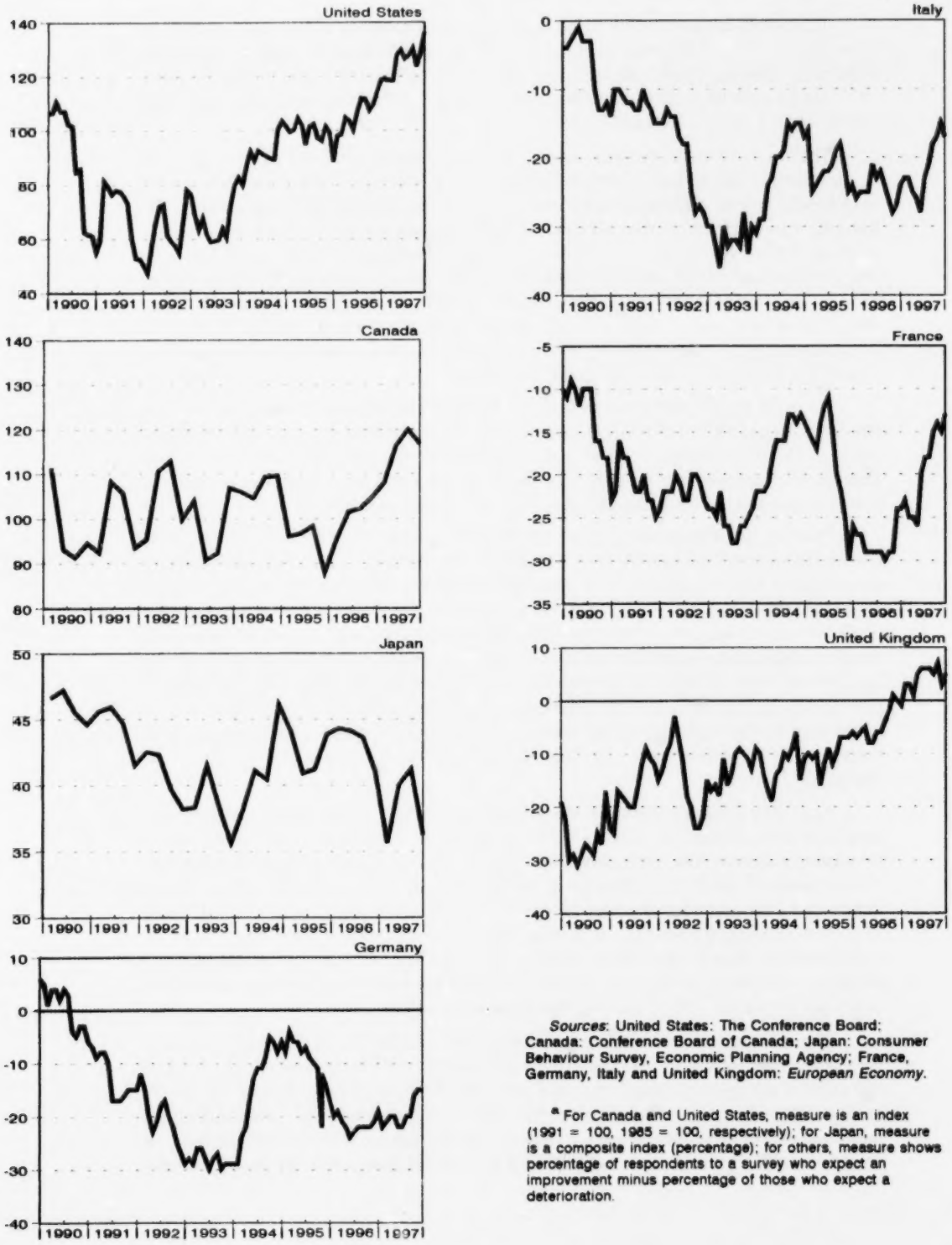
As 1998 began, domestic demand maintained considerable momentum and the strength in spending is likely to continue. Consumer confidence remains very solid (see figure II.1), while residential investment is on the rise. Business investment, though, is likely to slow somewhat. New orders for capital goods, however, suggest that investment will continue to grow more rapidly than output for quite some time.

Overall, gross domestic product (GDP) of the United States in constant prices is forecast to grow 2.7 per cent in 1998. The most uncertain aspect of the outlook is the size of the fallout from the Asian crisis. Thus far, the effect of the Asian crisis has not been significant. However, it is not quite clear yet to what extent, if any, a further deterioration in the net export position of the United States would offset the positive influences on demand coming from lower interest rates, falling commodity prices and cheaper imports and, hence, exert a drag on total output in the United States. Also, were inflationary pressures to begin to strengthen, monetary policy could be significantly tightened. This could lead to major downward corrections in both the bond and stock markets, with negative effects on consumer spending. The probability of such a change is, of course, uncertain.

Economic growth in **Canada** was also strong in 1997, supported by low domestic long-term interest rates (see table A.9) and strong import demand from the United States. Low interest rates were the reflection of low inflation and a dramatic cut in the fiscal deficit. The expansion – unlike the situation in the earlier years of the recovery, during which exports were the mainstay of economic growth – has become more broadly based. Since mid-1996, consumer spending, as well as business investment in technology and new equipment, has been the driving force in the economy. The pick-up in economic activity to close to an annual rate of 4 per cent has contributed to a fall in the unemployment rate to 8.9 per cent at the end of the year, the lowest since 1990.

The economic outlook of Canada remains quite positive. Given that trade with Asia, including Japan, makes up less than 10 per cent of Canada's total exports, the potential reduction of the country's export markets due to the Asian crisis is likely to be relatively modest. While the implications of lower prices of primary commodities – among the most important export items for Canada – cannot be ignored, the economic performance of the country's major trading partners, primarily the United States and Western European

Figure II.1. Consumer confidence in seven major economies,[a] 1990-1997



Sources: United States: The Conference Board; Canada: Conference Board of Canada; Japan: Consumer Behaviour Survey, Economic Planning Agency; France, Germany, Italy and United Kingdom: *European Economy*.

[a] For Canada and United States, measure is an index (1991 = 100, 1985 = 100, respectively); for Japan, measure is a composite index (percentage); for others, measure shows percentage of respondents to a survey who expect an improvement minus percentage of those who expect a deterioration.

countries, is likely to be strong enough to offset such adverse effects. At the same time, domestic demand is forecast to stay robust; consumer confidence has been improving for two years (figure II.1). Despite significant rises in short-term interest rates since mid-1997, the favourable inflation outlook has been keeping long-term borrowing costs low and providing a powerful impetus to both business investment and household spending on consumer durables and housing.

Western Europe: growth and the jobs problem

In its fifth year of expansion, the economy of the **United Kingdom of Great Britain and Northern Ireland** grew at about 3 per cent in 1997, against 2.6 per cent in 1996. Largely as a consequence of rapid income growth, consumer spending was quite strong. The other domestic spending components – gross fixed investment, government spending and stock building – also contributed to growth, but to a lesser extent. Despite the significant appreciation of the pound sterling since August 1996, trade had little net effect on output growth. The labour market continued to tighten and the unemployment rate fell to 6.6 per cent, the lowest since 1980, while inflation accelerated somewhat but was still about 3 per cent.

In 1998, the British economy is expected to slow somewhat to a growth rate of about 2.3 per cent, owing to the lagged impact of the 1997 rise in the real exchange rate (see table A.10) as well as to the lagged response to previous increases in short-term interest rates and an ongoing tightening of fiscal policy. After an unusually long delay, the sharp appreciation of the pound against other major currencies has begun to affect both exports and imports. As a result, the trade balance is weakening and trade is likely to be a significant drag on economic growth. Domestic demand, on the other hand, is forecast to decline only gradually. Indeed, while growth in consumer spending is forecast to slow down marginally, fixed investment is expected to grow slightly faster in 1998 due to increases in private and public investment in dwellings. Some reduction in stock building may also curb output growth, but only marginally.

With another year of robust economic growth in 1997, **Ireland** continues to warrant its nickname as the "green tiger".[1] After having achieved 7.7 per cent growth in 1996, it rose to an estimated 8 per cent in 1997. Compared with the record in the 1980s, during which economic activity was propelled by the external sector, the economic expansion in the 1990s has been more broadly based and this trend will continue in 1998, based on continuing strong consumer confidence and the prospect of lower interest rates. The acceptance of Ireland as a founding member of the monetary union in Europe is contributing to this prospect. The unemployment rate, long a particularly difficult economic and social concern, is forecast to slip into single digits in 1998, while inflation will accelerate slightly owing to credit expansion and wage pressures. Indeed, with a relative shortage of skilled workers in certain key sectors, some Irish émigrés are returning.

Exports provided a strong impetus to the growth of **France** and **Germany** in 1997. The depreciation of their currencies, both by roughly 15 per cent against the dollar, helped boost their exports. While the strong export performance produced a surge in investment in machinery and equipment in Germany, it led to higher capacity utilization rates and lower inventory levels in France. In 1998, private investment in both countries will pick up

[1] See "Fiscal correction with economic growth: Ireland becomes a 'green tiger'" in *World Economic and Social Survey, 1997* (United Nations publication, Sales No. E.97.II.C.1 and corrigenda), chap. VII, section entitled "Fiscal correction with economic growth: Ireland becomes a 'Green Tiger'".

further, as business confidence has been boosted by the confirmation of the start of the third stage of Economic and Monetary Union (EMU) at the beginning of 1999. This will also raise prospects for profitable investment opportunities in these, the two largest economies in EMU. In the short run, however, the growth of French and German exports is likely to decline because of the Asian crisis and the slower growth expected in the United States economy. Consumer spending is likely to pick up in France, reflecting the steady improvement in consumer confidence (figure II.1), while in Germany consumer spending is forecast to increase only slightly because of the introduction of a higher value-added tax (VAT) in April 1998. Overall, economic growth in 1998 in both countries will improve slightly from the 1997 levels, with domestic components becoming a more important source for growth. Yet, economic conditions will still not be dynamic enough to make a significant dent in the high unemployment rate (see table A.6).

The economic recovery of **Italy** in 1997 was supported by private consumption – spurred by incentives for automobile purchases – and investment. As in France and Germany, the depreciation of the currency helped boost exports but, in contrast to the situation in those countries, the acceleration in economic activity increased imports more than exports, resulting in a negative contribution of the external sector to overall GDP growth. What was spectacular in Italy was the reduction in the fiscal deficit by almost 4 percentage points in GDP from the 1996 level, without this causing a contraction in the economy. The accommodating monetary policy, made possible by the low inflation rate, also contributed to lower interest payments by the Government. The economy of Italy is forecast to sustain its upward trend in 1998, with private consumption and investment being the leading sectors again. In particular, investment is likely to accelerate strongly as interest rates are expected to remain low and Italy's admission to monetary union will improve the overall prospects for the economy. While inflation will remain low, unemployment will remain high.

Economic growth reached 3.4 per cent in **Spain** in 1997, with broadly balanced support from both domestic and external sectors, despite an austere fiscal stance. The introduction of a higher rate of VAT in October 1997 did not significantly affect overall inflation; the annual inflation rate fell to 2 per cent. Economic activity is forecast to accelerate further in 1998 with private consumption and private investment both rising.

In respect of economic growth, **Austria**, **Belgium**, **Greece**, **Portugal**, **Switzerland** and **Sweden** all strengthened in 1997. These economies are forecast to maintain their momentum in 1998, with private consumption and investment replacing exports as the main source for continuing growth. Belgium, however, is likely to experience a slowdown in investment activity, although the export sector will remain robust. While **Norway** experienced a slowdown in economic growth in 1997 owing to a decline in export growth and a temporary pause in consumption growth, it is forecast that the economy will regain its growth momentum in 1998 with the broad support of both domestic and external components. The economies of **Denmark**, **Finland** and the **Netherlands** also showed robust growth with more broadly based support than the smaller economies mentioned above. While Denmark and the Netherlands are forecast to achieve a similar growth record in 1998 thanks to robust exports, domestic activity will slow down. Investment activity in Finland is forecast to decelerate in 1998 as the monetary authorities raise interest rates to control inflation. The continuing improvement in the labour market – though unemployment is still at a historically high level – will support the continuation of robust private consumption.

Despite the acceleration of economic activity in 1997, the employment situation in Western Europe did not significantly improve. While the countries that are more advanced

in their economic recovery saw a decline in unemployment, the rates increased in Germany, France and Italy (table A.6). The strengthening of economic activity in 1998 is likely to create additional employment and therefore bring unemployment rates down, if only marginally; 1998 will thus likely be the sixth consecutive year of double-digit unemployment.

As the experience in the recent past has shown, modest rates of economic growth are not sufficient to reduce unemployment significantly in the region. The key policy dilemma has been how to raise the growth rate without setting off unacceptable inflation rates or jeopardizing achievement of the policy criteria for entering EMU. The European answer has been to try to tackle the structural impediments to job creation. This was the context in which EU leaders adopted a new strategy to tackle unemployment in a jobs summit held in November 1997. The main idea in the strategy was to establish a set of common guidelines (or targets) for policy measures for job creation. National authorities would then be required to incorporate the guidelines into national action plans. The plans would be presented to an EU summit in June 1998 and, subsequently, would be subject to annual peer review – a process similar to that employed successfully in preparation for monetary union.

As part of their national action plans, France and Italy introduced legislation for a 35-hour working week. The new policy aimed to create employment by reducing working hours and offering tax incentives to enterprises that created new jobs. The idea behind the legislation seems simple: shorter working hours per employee will increase the number of employees needed to produce the same output. There are, however, many sceptics. As the experience of Germany demonstrated, shorter working hours do not necessarily lead to the desired result. The creation of new jobs also depends on the growth of the economy, on the degree of flexibility and other features of the national labour market, on how national pension schemes operate and, increasingly, on a country's particular economic circumstances.

Despite the acceleration of economic activity in 1998, the inflation outlook for continental Europe is benign. There are three main reasons. First, there still exists a substantial gap between potential and actual production levels in most countries, though this gap is shrinking. Second, the determined efforts of policy makers to achieve and maintain economic and price stability and the success of their efforts have earned them a high degree of credibility in the market, resulting in lower inflation expectations and lower long-term interest rates. This should help raise investment and thus enhance productivity. Third, a short-run factor, the Asian crisis, has had a dampening effect on prices. Along with lower prices for imports from the countries affected, there has also been considerable downward pressure on the prices of oil and metals.

Asia and the Pacific: three divergent economies

Output in **Japan** declined in the fourth quarter of 1997. Even before that, in the second quarter in 1997, the economy had recorded one of the largest drops in GDP in recent Japanese history, albeit following an unusually strong first quarter (see table II.1). This reflected anticipatory spending and then a sharp cutback due to the introduction of a higher rate of sales tax in April 1997, the elimination of special tax exemptions and increases in charges to the public for medical services. Towards the end of the year, there was a sharp increase in inventory levels and private investment, which had been leading economic growth in the first half of the year, started to slow. The consumption shock from the tax increase and the export shock from the Asian crisis had exacted their toll. Public spending was a drag on GDP growth, reflecting the Government's renewed commitment to fiscal consolidation. Overall, the economy grew 0.9 per cent in 1997, most of which came about in the first quarter.

Table II.1. Major industrialized countries: quarterly indicators, 1996-1997

	1996 quarter				1997 quarter			
	I	II	III	IV	I	II	III	IV
	Growth of gross domestic product [a] (percentage change in seasonally adjusted data from preceding quarter)							
Canada	1.4	1.4	3.3	2.9	3.4	4.9	3.9	3.0
France	5.1	-0.5	3.1	0.6	1.2	4.5	3.6	3.2
Germany	-0.4	6.1	3.0	0.3	1.8	4.1	3.2	1.1
Italy	2.4	-3.5	2.9	-0.1	0.1	7.8	2.6	0.7
Japan	8.4	-1.1	-1.6	4.3	8.3	-10.6	3.2	-0.7
United Kingdom	1.5	2.3	2.8	3.3	3.3	3.2	3.2	2.4
United States	2.0	4.7	1.0	4.3	4.9	3.3	3.1	3.7
Total	3.6	2.2	1.0	3.2	4.7	0.3	3.2	2.0
	Unemployment rate[b] (percentage of total labour force)							
Canada	9.5	9.6	9.8	9.9	9.6	9.4	9.0	8.9
France	12.1	12.4	12.5	12.6	12.5	12.5	12.5	12.4
Germany	8.9	8.9	8.8	9.1	9.4	9.6	9.9	10.0
Italy	12.0	12.0	12.0	12.0	12.2	12.1	12.1	12.2
Japan	3.3	3.5	3.3	3.3	3.3	3.5	3.4	3.4
United Kingdom	8.4	8.3	8.2	7.8	7.5	7.2	7.0	6.6
United States	5.6	5.4	5.3	5.3	5.2	4.9	4.8	4.6
Total	6.9	6.9	6.8	6.8	6.7	6.6	6.6	6.5
	Growth of consumer prices [c] (percentage change from preceding quarter)							
Canada	1.8	2.9	0.7	2.5	2.5	1.1	1.0	-0.3
France	2.9	3.2	-1.0	1.7	2.1	0.7	0.7	1.1
Germany	2.5	2.1	1.4	-0.3	3.8	1.4	3.1	-0.7
Italy	4.4	4.6	0.9	1.8	2.7	2.1	0.6	2.7
Japan	-1.1	3.0	-0.8	1.1	-1.1	8.9	0.0	1.1
United Kingdom	2.0	5.5	0.7	2.3	2.3	5.3	3.9	3.2
United States	2.3	4.1	2.0	3.0	2.7	1.6	1.6	1.6
Total	1.6	3.7	0.8	2.0	1.8	3.5	1.4	1.3

Source: United Nations, based on data of International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD) and national authorities.

a Expressed at annual rate (total is weighted average with weights being annual GDP valued at 1993 prices and exchange rates).
b Seasonally adjusted data as standardized by OECD.
c Expressed at annual rate.

The outlook for 1998 is one of virtual economic stagnation.[2] The external sector has to cope with the slowdown of exports to East Asian economies, although the recent depreciation of the yen, reflecting vast capital outflows from the country, will help increase the competitiveness of Japanese products in the global market. Private consumption, the largest component of GDP, is forecast to stay flat or even to decline slightly, owing to the upward creep in unemployment rates and the loss of consumer confidence, which was shaken by the series of collapses of some large corporations in recent months. Furthermore, lower prices of stocks and real estate are likely to reduce the propensity to consume in 1998; that is to say, households will tend to attempt to maintain the value of real assets by altering their consumption. Also, surveys conducted in early 1998 have predicted declines in private investment, because of weak domestic and external demand, as mentioned above.

Robust investment was behind the acceleration of economic activity in **Australia** in 1997. The fall in inflation rates that was facilitated by the weakness in import prices made it possible for the monetary authority to lower official interest rates several times throughout the year, spurring investment even further. The expansion created a significant number of new jobs, and led to wage increases, rising household incomes and an increase in private consumption. The economy is forecast to maintain much of its momentum in 1998, with more robust private consumption and a slightly expansionary fiscal stance. However, as the depth and duration of the crisis in Asia are becoming clearer, the growth forecast for Australia has had to be lowered, indeed by as much as 1 percentage point from the rate forecast in late 1997. The fact that declining exports to the region may worsen the current account deficit and depreciate the currency against the dollar could in turn build up inflationary pressures.

New Zealand was at the bottom of its cyclical slowdown in 1997, with growth in most components of demand having weakened. The exception was public consumption, reflecting a slightly expansionary fiscal stance after the years of successful fiscal consolidation. Accordingly, in late 1997, the economy was forecast to accelerate but the Asian crisis has adversely affected consumers' and investors' confidence. As a result, private consumption and investment are not expected to rebound as strongly as had been forecast and exports are likely to rise only marginally. The expected deterioration of the current account balance will exert downward pressures on the currency.

Macroeconomic policy stances

With the very important exception of Japan, macroeconomic policy makers in developed countries have largely accomplished the goals they set out to achieve – low inflation, smaller budget deficits and sustainable growth (although current growth rates are undoubtedly below the sustainable trend rate in several countries). Policies in 1997 and early 1998, not surprisingly, continued to follow the same strategies, albeit with Japan facing a unique challenge.

In the **United States** in March 1997, amid clear signs of economic acceleration, the federal funds rate was raised a quarter percentage point to 5.5 per cent. Since then, despite strong growth and a tight labour market, there has been no further increase in short-term interest rates. To the surprise of some, inflation actually fell. This fall can be attributed to the appreciation of the dollar, weakness in international commodity prices, and faster productivity growth. In fact, even without any upward move in nominal short-term interest rates, overall monetary conditions in the United States became less stimulative after March

[2] This outlook does not take account of proposed fiscal stimulus packages that were under discussion in April, but had not yet been legislated.

1997, owing to the drop in inflation expectations, and thus the rise in the real federal funds rate, as well as to the rise in the foreign exchange value of the dollar.

The federal budget deficit of the United States declined from 1.25 per cent of GDP in fiscal year 1996 (October 1995 to September 1996) to 0.2 per cent in fiscal year 1997. The current expansion has contributed importantly to this outcome. However, a series of budget reforms also helped to improve the fiscal position.[3] On present trends, the federal budget is likely to be in a small surplus in fiscal year 1998 and, despite several tax cuts proposed, the planned restraint in expenditure will ensure that the budget stays in surplus over the next five years. This forecast rests, however, on the assumption of no significant rise in interest rates, as well as on a 2.5 to 2.8 per cent annual growth rate in GDP over the same period.

Amid accelerating growth and downward pressures on the Canadian dollar, monetary policy in **Canada** tightened significantly in 1997, representing a turnaround from the long-held stance of a highly stimulative policy. From the summer of 1997 through February 1998, short-term rates were raised by 2 percentage points to 5 per cent. Real rates rose even more, on the order of 2.5 percentage points, because of falling inflation. This has applied an additional "passive" measure of restraint on demand. Given continued strong expansion in output and employment, as well as the continuing weakness of the national currency, monetary policy is likely to continue to be biased towards tightening.

In fiscal policy, the Canadian federal Government achieved its objective of a balanced budget in 1997; modest surpluses are expected for the future. Moreover, the ratio of federal debt to GDP registered its second consecutive decline in 1997 to about 68 per cent, down from 74 per cent in 1996 and a high of 74.5 per cent in 1995. The striking fiscal success has turned around the attitudes of financial markets towards Canadian economic prospects. Indeed, whereas during the 1994-1995 Mexican currency crisis, long-term interest rates in Canada increased sharply as the country's fiscal problems caused investors to demand a higher risk premium,[4] the events in Asia since the summer of 1997 have been accompanied by a fall in Canadian long-term interest rates to their lowest levels in 30 years.

In the **United Kingdom**, faced with strong growth and with inflation consistently above the target of 2.5 per cent, the Bank of England raised interest rates in stages from 6 per cent in May 1996 to 7.25 per cent in November 1997, even though this led to a further appreciation of the sterling, weakening British competitiveness internationally. Since then, no further rate hikes have been implemented. The central issue for the Bank is whether the existing policy stance will slow the economy sufficiently to prevent further upward pressures on prices, but not more than is deemed necessary.

In **continental Western Europe**, the most important issue in 1997 and early 1998 was to achieve a ratio of the budget deficit to GDP that was no more than the 3 per cent maximum as set forth in the Maastricht Treaty on European Union, and to narrow the interest rate gaps that existed among member countries in order to pave the way for a smooth transition to monetary union. In fact, all the 11 countries that wanted to – and will – enter the monetary union at its inception had deficits below or at the maximum ratio in 1997. While fiscal discipline was the major factor in reaching the target, some countries employed various one-off measures, such as sales of State-owned enterprises (SOEs), the introduction of temporary special-purpose taxes and "adjustments" in fiscal accounting. Also, more

[3] See *World Economic and Social Survey, 1997* (United Nations publication, Sales No. E.97.II.C.1 and corrigenda), chap. VI, subsection entitled "Successive budget strategies in the United States".

[4] For details, see *World Economic and Social Survey, 1995* (United Nations publication, Sales No. E.95.II.C.1), chap. IV, subsection entitled "Budgetary policy under minimal guidelines on debt".

robust growth in 1997 than forecast at the beginning of that year helped reduce the deficit-to-GDP ratio: tax revenues rose and some government expenditures were less than they would have been.

Fiscal discipline is expected to continue in place in 1998 and beyond. Once the monetary union is established in January 1999, responsibility for monetary policy moves to ECB. Thus, member countries will have to rely almost exclusively on fiscal policy to address country-specific economic shocks, but even this option is restricted by the agreement in the Stability and Growth Pact of December 1996 to maintain fiscal deficits under 3 per cent of GDP in perpetuity. In order to ensure the flexibility and manoeuvrability of fiscal policy within the constraints and obligations of the Stability and Growth Pact, it will be essential to move towards zero deficits. In this respect, it is also considered crucial for many countries to reduce the ratio of government debt to GDP, as highlighted by the European Monetary Institute (EMI) report on convergence in March 1998.[5]

During the course of 1998, the 11 future member countries of the single currency area are expected to lead their short-term interest rates to a common rate. As there still do, and almost inevitably will, remain differences among member countries in terms of their position in the business cycle, attempts to bring interest rates to the common rate have a potential to create tensions. In general, high interest rate countries, such as Ireland, Italy, Portugal and Spain, are likely to cut interest rates as long as inflationary pressures do not build up excessively, while low interest rate countries are expected to maintain their rates or to increase them slightly, based on the relatively bright economic growth forecast. In certain cases, however, countries may need to deviate from this general pattern. For example, Finland, whose short-term interest rate had been below Germany's for some time, raised it above the German rate to prevent the economy from overheating. Conversely, Germany may have an incentive to lower its short-term interest rates under the current economic conditions of high unemployment and continuing low inflation.

In the longer term, there are many challenges that member countries will face. In fact, it may be argued that the real challenge lies in sustaining the monetary union, rather than in creating it. Europe is not a federal State, unlike the United States. There is no large central budget to absorb economic shocks and redeploy resources in response. Also, the member countries have different tax and fiscal expenditure systems, labour mobility between them is still highly limited, pension systems are very different and pension rights are not automatically transferable between them. For all these reasons, the policy architecture of EU in the twenty-first century seems incomplete. However, the impressive achievements made by the European countries in order to assure that monetary union will begin in January 1999, the steps already achieved to create a single market, and the drastic effects of a future failure of monetary union on European union and confidence in economic management furnish reasons to expect that over time the European States will find solutions to the various problems that arise on the road to a deeper union.

In Japan, meanwhile, policy makers continue to face extreme difficulties in choosing a policy mix. While the Bank of Japan has little choice but to maintain an easy monetary policy in the face of stagnant domestic demand, the large gap that exists between potential and actual output, along with the decline in the prices of imports from the rest of East Asia, could set in motion a deflationary spiral. Another pressing issue is the continuing overhang

[5] The Maastricht Treaty adopted a target for the ratio of government debt to GDP of no more than 60 per cent. Several Governments are well above that target, although the stronger fiscal positions held out a promise of progress in reducing the ratio over time (see *European Monetary Institute, Convergence Report: Report required by Article 109j of the Treaty establishing the European Community* (Frankfurt and Main, March 1998).

of bad loans in the banking sector. Even though, in March 1998, the Government injected 1.8 trillion yen (¥) ($14 billion) into the 21 banks that had requested public funds, the banks did not significantly expand loans. The expansion of loans that are envisaged by the 21 banks may not, based on the restructuring plans submitted, provide sufficient credit to small- and medium-sized enterprises, which are being squeezed by a "credit crunch".[6]

The Government is facing a dilemma in fiscal policy as well stemming from the conflict between the short-term need to revive the economy and the long-term objective of ensuring the sustainability of the country's social security system. This is the concern that motivated the Government to implement an only temporary ¥2 trillion income-tax cut as part of its 1998/99 budget rather than a permanent reduction in tax rates. The fiscal authorities were afraid that, in the event of a permanent reduction, the revenue from income taxes would be insufficient to achieve the fiscal balance required according to the terms of the fiscal reform law of December 1997.[7] As indicated in the previous section, however, the weakening in 1997 of consumer confidence and the decline in the real value of wealth held by the consumer sector will most likely lead consumers to channel their additional disposable income coming from the tax break into savings. Therefore, a temporary tax break is not expected to boost economic activity. For this reason, some politicians and economists have been suggesting the need for permanent income and/or corporate tax cuts.

As of the end of April 1998, it appeared likely that the Government would implement some form of tax cuts on a multi-year basis and will undertake additional public investment projects. While such new initiatives would help lift the Japanese economy in 1998 and 1999, their effects would not likely last beyond these years. Several fiscal measures implemented during the 1990s failed to produce sustained economic recovery. During the period, private enterprises, both financial and non-financial, put aside at least part of the additional revenues made possible by those fiscal injections to improve their balance sheets. Therefore, the expected income-expenditure dynamics did not materialize. While it is encouraging that the Government appears to have decided to amend the fiscal reform law to allow it to pursue a more flexible fiscal policy, it may have also to take more direct actions to strengthen the balance sheets of private enterprises.

The transition economies

After seven years of often sharp decline, the GDP of the transition economies as a group increased, finally, in 1997; growth is expected to accelerate to about 3 per cent in 1998.[8]

As encouraging as these aggregate numbers are, they mask the great disparity in the performance of individual countries, ranging from a decline in output of about 20 per cent to an advance of over 11 per cent (see table A.3). Most Central and Eastern European countries, as well as the Baltic States, have been growing since 1994, while in Belarus, the Caucasus and most countries of Central Asia the recovery began in 1995 or 1996. This

[6] Strictly speaking, the credit crunch is only one side of the story. Commercial banks do not simply deny new loans to small- and medium-sized enterprises; they are now trying to evaluate risks associated with loans on the basis of more market-based criteria.

[7] The law requires the Government to cut its ratio of fiscal deficit to GDP to 3 per cent by the year 2003.

[8] For additional details on recent developments in the transition economies – more than can be presented here – see *Economic Survey of Europe, 1998 No. 1* (United Nations publication, Sales No. E.98.II.E.1); and *Economic and Social Survey of Asia and the Pacific, 1998* (United Nations publication, Sales No. E.98.II.F.59).

notwithstanding, aggregate transition economy GDP continued to decline although at a diminishing rate, until the Russian Federation, by far the largest economy in the grouping, achieved its first measured advance since 1989. Although GDP fell in 1997 in Albania, Bulgaria, Romania, Turkmenistan and Ukraine, all those countries are expected to grow in 1998.

With the exceptions of Bulgaria, Kyrgyzstan and Turkmenistan where economic expansion is being driven by exports, the recovery has been mainly underpinned by domestic demand. Except in the Russian Federation, this has resulted in a widening of current account deficits; in 1997, most deficits were equal to or higher than 5 per cent of GDP. The fact that, as the recoveries gain momentum, external imbalances are expected to increase further, is an issue that policy makers will need to address.

Inflation, however, has been consistently trending downwards in most countries. Nevertheless, in Belarus, Romania, Tajikistan and Turkmenistan, prices still rose at an annual rate of over 50 per cent (see table A.8). The most dramatic case has been Bulgaria, where inflation accelerated during the first half of 1997 to more than 1,000 per cent at an annual rate. However, after the introduction of a currency board in July 1997, inflation decelerated sharply.

Since the start of transition, unemployment has become one of the most important economic, social and political issues. Although officially reported unemployment rates range from 1-2 per cent to close to 20 per cent, the problem is much more serious than official numbers suggest because of very significant hidden unemployment.

Fragile expansion in the European member countries of the Commonwealth of Independent States

Perhaps the most important development of 1997 was that the economies of the Russian Federation and Ukraine finally showed signs of nascent improvement.

In the Russian Federation, following a cumulative reduction of 43 per cent in total production between 1989 and 1996, real GDP rose by 0.4 per cent in 1997.[9] Industrial production was up 1.9 per cent over 1996, with large and medium-sized industrial enterprises accounting for much of the growth. Household consumption, underpinned by a partial payment of pension and wage arrears, as well as by household dissaving on account of concerns about the pending redenomination of the rouble, was the main driving force behind the recovery. Growth in 1998, while modest, could be above 1 per cent.

Since 1990, Ukraine's economy has contracted by about 55 per cent in real terms. For Ukraine, in contrast to the Russian Federation, 1997 marked another year of GDP decline – by about 3 per cent. However, this was a much smaller decline than in previous years. Besides, industrial production appeared to have stabilized in late 1997 and early 1998, with several industries, including fuel and metallurgy, showing increases in output. In the chemical and petrochemicals industries, production has stopped falling. No less important, in machine building there has been a pronounced deceleration of the rate of decline to low single digits against annual drops of 20 per cent since 1992. Also, there was a 4.2 per cent real increase in consumer goods purchases in 1997 as incomes rose. Output may grow by about 1 per cent in Ukraine in 1998.

[9] In the first half of 1997, the Russian Government adjusted its formula for determining changes in GDP by increasing the estimate of the Russian Federation's shadow economy from 20 to 23 per cent of GDP. This has resulted in more favourable comparisons than the old calculations would have provided.

Fixed investment continues to be a key weakness of both economies. In the Russian Federation, after an 18 per cent fall in 1996, fixed investment declined another 5 per cent in 1997. In Ukraine, investment fell by 9 per cent in 1997 against a decline of 22 per cent in 1996. In both countries, investment in 1998 is likely to remain at about its 1997 level because of political, legal and macroeconomic uncertainty.

Over the course of 1997, inflation declined from the 1996 average of 48 per cent in the Russian Federation and 80 per cent in Ukraine to close to a 15 per cent average. In 1998, Russian inflation is likely to stay at about the 11 per cent rate achieved by the end of 1997. In Ukraine, in contrast, inflation could accelerate from its end-1997 level of 10 per cent to close to 16 per cent, owing to one-off increases in administered prices.

Both the Russian and Ukrainian economies were vulnerable to contagion from the Asian currency crisis. The financial turmoil forced domestic interest rates to rise from less than 20 to above 40 per cent to support the rouble and the hryvnya. Interest rates have since fallen somewhat from their peak in February 1998 as psychological concerns eased, but are likely to remain well above their pre-crisis levels during the current year. Given the relatively low share of private credit in the two economies, the main impact of higher interest rates will be to increase government debt-service costs and bring about new cutbacks in other government expenditure items. It will thus be more difficult to reduce the backlog of wage arrears. The situation is likely to be exacerbated by sharply higher costs of international borrowing, as foreign market lenders are already exacting a higher risk premium on credits extended to these countries.

The inability to put public finances on a sounder footing was the most important policy failure in 1997. The major cause of this failure was the incapacity to collect the revenues necessary to cover planned expenditures. As a result, up to 30 per cent of expenditures have been slashed and budgetary non-payments to workers and suppliers have been rising. Higher borrowing costs, meagre growth prospects and weaker trade developments in 1998 could again jeopardize budget outcomes. Especially in the case of Ukraine, the financing of the budget deficit could become a problem as a result of the virtual collapse of the treasury-bill market in the aftermath of the Asian crisis. This was largely due to the exodus of foreign investors whose share of the market had been about 50 per cent. The Government's response has been a significant fiscal tightening, with the projected budget deficit for 1998 being cut from 3.3 per cent of GDP to 2.5 per cent.

However much desired, continued progress in macroeconomic stabilization per se will not be enough to ensure that these countries move quickly to rapid growth. Real interest rates are expected to remain high, restraining the main components of domestic demand. Another curb on demand will be mounting non-payments, including wage arrears. Household consumption, which provided an important stimulus to the two economies in 1997, is not expected to be a leading sector of demand over the long term, while fiscal constraints will not allow the use of government consumption to boost overall demand. An investment-led recovery also looks unlikely to occur soon because of demand and liquidity constraints, as well as the continuing deterioration of the financial position of enterprises. Indeed, in 1997, both in the Russian Federation and Ukraine, almost half the firms made losses.

In the case of Ukraine, with domestic demand subdued, any economic turnaround will perforce have to rely on an upturn in sales to its trading partners, firstly in the Russian Federation. Trade between Ukraine and the Russian Federation, which declined by 18 per cent in the first nine months of 1997 as a result of a trade dispute, should grow markedly following the November 1997 agreement between the two countries to eliminate the VAT on each other's exports.

In the case of the Russian Federation, exports are not likely to contribute significantly to growth in the short run as the prices for raw and intermediate materials exports will remain weak. Moreover, the capacity to increase the volume of raw materials exports is limited in the short run. Stronger trends in manufactured exports to offset the weakness in commodities can hardly be expected over the next several years.

According to official estimates, after several years of contraction, real GDP in Belarus increased by 2.8 per cent in 1996 and 10 per cent in 1997. The prospects are that economic growth in 1998 will also be positive. Growth is being underpinned by the State's policy of rapid credit expansion, which took the form of directed and subsidized loans by the National Bank of Belarus, the central bank, mainly to the agro-industrial and housing sectors. The directed credits spurred investment in the targeted industries which appears to have stimulated overall demand. In 1997, the volume of trade increased by more than 25 per cent, with exports growing faster than imports.

Faster growth came at a price of higher inflation, which accelerated from 53 per cent in 1996 to 64 per cent in 1997 and may reach 100 per cent by 1999. In addition, the economic boom has led to a severe currency crisis: the Belarusian rouble fell more than 30 per cent against the dollar during the first 20 days of March 1998. In response, the central bank increased interest rates (which, however, remained negative in real terms even after the rise) and further tightened restrictions on foreign exchange transactions. Moreover, the Government ordered all State and private companies to reduce prices (which had been forced up by the currency fall) to their pre-crisis levels, effectively introducing a price freeze. Given the continued rapid rates of credit expansion for financing the economy, inflation would be suppressed rather than curtailed.

The Republic of Moldova's GDP grew by 1.3 per cent in 1997, the first advance since independence, while inflation fell to 12 per cent from 24 per cent. Yet the economy remains at about one third of its pre-independence size. Growth is likely to accelerate to a 3-4 per cent annual rate in 1998, assuming that continued foreign assistance and normal weather conditions prevail, as agriculture accounts for more than 30 per cent of the Republic of Moldova's GDP.

The Central Asian and Caucasian republics: vulnerability of commodity-focused growth

In 1996 and 1997, signs of economic revival began to become apparent in the Central Asian and Caucasian countries. In 1997, GDP increases between 2 and 12 per cent were registered in all the Caucasian countries and in Central Asia, with the exception of Turkmenistan. In most countries, GDP advances were underpinned by the influx of foreign capital, including foreign direct investment primarily attracted into the oil and gas industries, with the latter accounting for between 20 and 80 per cent of gross capital formation. Also, an important driving force behind the recovery in several countries has been the export of primary commodities.

In 1997, Turkmenistan illustrated the consequence of overdependence on a narrow range of exports, as the economy collapsed: GDP dropped by about 20 per cent as natural gas production, which accounts for up to 50 per cent of output, plunged by more than 50 per cent after the country halted almost all gas exports in March 1997. The decision to suspend gas exports, which account for nearly two thirds of total export sales, was motivated by the non-payment for earlier deliveries by Ukraine, Turkmenistan's major customer, and Georgia. Total gas debts owed to Turkmenistan are close to $2 billion (equivalent to about 95 per cent of the country's GDP). Moreover, because of the poor cotton crop, the production of cotton fibre, the second major export item, came in at only

20 per cent of its 1996 volume. This dual setback produced a dramatic deterioration in government finances, as taxes on exports of natural gas and cotton fibre provide almost 70 per cent of government revenues. The Turkmen economy is likely to post modest growth in 1998, as gas production and exports rebound gradually, following the resumption of deliveries to Ukraine. Cotton-related activities should also pick up because of a better harvest in the fall of 1997.

With the notable exceptions of Tajikistan and, especially, Turkmenistan, inflation is being reduced (see table A.8). However, only in the Caucasian republics did it drop below 10 per cent; in Kazakhstan, Kyrgyzstan and Uzbekistan consumer prices are still growing at an annual rate of between 20 and 50 per cent.

According to official data, despite the drastic reductions in output in previous years, registered unemployment has remained surprisingly low: on the order of 1 per cent (Azerbaijan) to 10 per cent (Armenia). However, hidden unemployment could be much larger, as there is significant rural overpopulation and the bulk of the working-age urban population is still formally registered as employees at enterprises that are working, at best, at between 10 and 25 per cent of capacity. In this regard, it was estimated in the 1980s that, according to Soviet standards, around 30 per cent of industrial employment in those regions was superfluous. This can be considered a minimum figure in today's economies.

The prospects for 1998 and beyond depend on the ability to raise domestic saving and investment, as well as to attract foreign capital inflows into a broader range of industries. For instance, in **Kyrgyzstan**, up to 80 per cent of foreign investment has been directed to only one project: the development of the gold deposit at Kumtor.

In **Kazakhstan**, foreign direct investment surged – it was close to 6 per cent of GDP (see table II.2) – which brought the ratio of gross fixed investment to GDP to 12 per cent in 1997. Yet in 1987-1990, when there was negligible foreign direct investment, the share of investment was higher, at 19 per cent of GDP. Foreign investment, as well as output growth, is heavily concentrated in the oil and gas sectors and, to a lesser extent, in metallurgy. At the same time, mechanical engineering, chemicals and petrochemicals, electricity, light industry, construction materials and the food industry as well as agricultural production are still in decline.

In **Azerbaijan**, oil-related foreign investment – which has contributed importantly to the very high investment-to-GDP ratio of about 25 per cent, the highest ratio among all the transition economies – is helping to stabilize the economy and ensure its strong, though rather narrowly based, growth. Most non-oil sectors are lagging far behind. Indeed, in 1997 when overall GDP growth was about 6 per cent, industrial production stayed almost flat. Concerned about these developments and about overdependence on the oil sector, the Government has drawn up an investment programme for the period to 1999 that aims to revive non-oil industries. Implementation of the programme depends, however, on an even greater, but less narrowly focused, inflow of foreign investment. As a result, in the next several years, the current account deficit, which was close to 22 per cent of GDP in 1997, might widen further to close to 30 per cent. Growing foreign obligations undertaken on the basis of future hydrocarbons revenues make the economy increasingly vulnerable to changes in oil prices as well as to other adverse developments in export markets.

The need to overcome the economy's high degree of dependence on mainly two commodities – gold and cotton – remains among the policy priorities in **Uzbekistan** which has been successful in the pursuit of this policy. It has attracted considerable foreign investment into a broader range of industries than its traditional export-oriented sectors of gold mining, uranium and non-ferrous metals. Foreign investment has already created

several branches of industry, such as automobiles, ball-bearings and electronics, which did not exist before independence. Also, foreign investment helped Uzbekistan become the only Central Asian economy thus far to have increased its oil and gas output since independence, although admittedly from a low level. Most of the newly formed industries are aimed at serving regional markets as they recover from post-independence recessions. The diversification strategy helped the country to achieve overall GDP growth of above 5 per cent in 1997 despite soft gold prices and the relatively poor cotton crop.

In 1997, with the end of hostilities, the **Tajik economy** registered its first growth since independence, of over 2 per cent, as agricultural production returned to more normal levels. However, the slump in industrial production, especially in aluminium, continues to hold back the recovery. Over the next several years, economic development will depend importantly on lending by multilateral organizations and continued humanitarian support from international donors. Other capital inflows are not expected to be forthcoming in the short run, while domestic resources have been largely depleted by the civil war.

To revive their economies, **Armenia** and **Georgia** are relying heavily on foreign assistance which covers 70 per cent and up to 40 per cent of government expenditures respectively. Foreign direct investment has thus far been modest, at about 1½ per cent of GDP (see table II.2). That the strongest growth in both countries has been in the service sector, particularly in trade, is typical for the early stages of transition. In contrast, industrial output has been depressed. For instance, in Georgia, only about 14 per cent of GDP comes from industry, against 42 per cent in 1991. Growth has been mainly fuelled by a boom in consumption, fed by increasing imports. With the notable exception of housing construction in Georgia, investment has remained subdued. Consumption-led recovery, has resulted in a significant current account deficit which in 1997 reached 15 per cent of GDP in Georgia and 22-24 per cent of GDP in Armenia. In the short run, the growing external imbalances will not derail the recovery, as foreign financing largely in the form of humanitarian assistance and loans to assist post-war recovery is likely to remain available. Hence, in 1998 growth will likely be maintained at an annual rate of about 5 per cent in Armenia and close to 10 per cent in Georgia. In the longer term, a sustained recovery of GDP growth from the post-independence collapse will require the stepping up of industrial restructuring and significant increases in investment. Given the shortage of domestic savings, attracting foreign investment could become one of the most important preconditions for sustainable growth and economic stability.

Table II.2. Foreign direct investment in the transition economies, 1989-1997
(Millions of dollars)

	1996	1997	1989-1997	Inflows as percentage of GDP (1997)
Central and Eastern Europe and the Baltic States				
Albania	97	33	369	1.4
Bulgaria	100	575	1 000	5.6
Croatia	509	500	1 276	2.7
Czech Republic	1 388	1 275	7 473	2.4
Estonia	111	131	809	2.8
Hungary	1 986	2 100	15 403	4.7
Latvia	379	415	1 287	7.6
Lithuania	152	327	612	3.6
Poland	2 741	3 044	8 442	2.3
Romania	415	998	2 389	2.9
Slovakia	177	150	912	0.8
Slovenia	186	321	1 074	1.8
The former Yugoslav Republic of Macedonia	12	16	65	0.5
Total	8 252	9 885	41 111	2.8
Commonwealth of Independent States (CIS)				
Armenia	22	26	70	1.6
Azerbaijan	661	1 006	1 993	24.4
Belarus	75	100	267	0.7
Georgia	25	65	104	1.3
Kazakhstan	1 100	1 200	4 267	5.7
Kyrgyzstan	46	50	247	3.1
Republic of Moldova	56	71	249	3.4
Russian Federation	2 040	3 900	9 743	0.8
Tajikistan	20	20	86	1.8
Turkmenistan	129	108	652	4.7
Ukraine	526	700	2 096	1.4
Uzbekistan	50	60	216	0.4
Total	4 750	7 306	19 990	1.2

Source: European Bank for Reconstruction and Development.

Central Europe and the Baltic States: consolidating the momentum

As has been noted already, the Baltic States and, with few exceptions, the Central and Eastern European Transition Economies (CEETEs) have been growing since 1994. For many, the major policy focus has turned towards advancing the institutional reform agenda and preparing for membership in EU. Macroeconomic management, with certain exceptions, has mainly sought to maintain a sustainable momentum.

Among the CEETEs, **Poland** has been the most dynamic economy, with average annual growth about 6 per cent since 1994. This growth in GDP is likely to continue well into the medium term. Growth is now being driven by domestic demand with both investment and consumption rising strongly. Indeed, in 1997, investment increased nearly 22 per cent and another rise of close to 20 per cent is forecast for 1998. A significant part of the increase in domestic demand is being met by imports, which are growing faster than exports. The resultant widening in the trade deficit may become a major policy concern. Strong growth has contributed to some fall in unemployment, which is likely to continue its gradual decline. Despite brisk economic performance, inflation keeps falling, but still remains well above 10 per cent. In 1998, the pace of economic activity may decelerate from 7 per cent to about 6 per cent, owing to tight fiscal and monetary policies and the rise in net imports.

In 1997, the consistent reform effort in **Hungary** showed more dynamic results, after several years of mediocre growth. The economy accelerated to above 4 per cent and is likely to grow at a higher annual rate in 1998. The major forces of growth have been investment, which registered a double-digit advance for the second year in a row, and exports. The recovery could become more broadly based, as there are signs of a pick-up in personal income. Growth is being underpinned by a fast and steady improvement in manufacturing productivity, suggesting that the large foreign investment inflows of the previous years have started to bear fruit. Hungary's acceleration in economic activity, unlike that in many other countries, has been accompanied by a decline in the trade deficit.

Economic activity in the **Czech Republic** and **Slovakia** decelerated over the last year. The Czech economy has suffered from a loss of competitiveness, owing to the fact that real wages are rising considerably faster than productivity, leading to a subsequent widening of the current account deficit. This necessitated significant monetary tightening and a currency devaluation. Growth is expected to rebound gradually over the next several years, as the negative effects of slower investment and consumption are offset by rising net exports. In Slovakia, a slowdown in gross fixed capital formation and government consumption, the result of policy tightening aimed at restoring macroeconomic stability, was only partly offset by exports. In 1998-1999, activity may decelerate again to an annual rate of slightly below 5 per cent, owing to a further slowdown in domestic demand. Hence, a kind of economic "soft landing", after the dangers of overheating, can be expected.

The economies of **Bulgaria** and **Romania** experienced a significant decline in 1997, which could be at least partly attributed to a long delay before making a serious effort to undertake economic reforms. Indeed, as a result of severe banking and foreign exchange crises, Bulgarian GDP fell by almost 11 per cent in 1996 and by another 7.4 per cent in 1997. In July 1997, Bulgaria introduced a currency board to help restore the confidence of economic agents.[10] The recovery in output is likely to be steady but slow. It is being led

[10] A currency board takes monetary policy out of the hands of the monetary authority and replaces the authority with a fixed mechanism: increases in domestic currency can be issued only against equivalent increases in foreign exchange reserves at the fixed exchange rate. Where monetary authorities have abused their money-creating power and driven up inflation, a currency board can help restore confidence.

by exports, as domestic demand, though improving, will stay sluggish for quite some time. In 1997, after several years of strong growth, the Romanian economy contracted as a result of a sharp drop both in investment and in consumer spending. The contraction in domestic demand was due to sharp subsidy cuts, price liberalization and a significant devaluation of the national currency. The further withdrawal of subsidies and the planned downsizing of the State sector raise doubts about the extent of any resumption of growth in 1998.

The economies of the successor States of the former Yugoslavia are growing, albeit from quite different bases. The economy of **Slovenia** has been relatively dynamic since 1993. Over the past two years, growth decelerated from above 4 per cent to about 3 per cent, owing to moderating growth of domestic demand. In 1998 growth could pick up again to close to 4 per cent, as investment recovers and exports, the major factor of growth in 1997, continue performing well. Over the past several years, the economy of **Croatia** has been on an accelerating path and the growth momentum will stay intact in 1998. As in many other transition economies, domestic demand, especially private consumption, grew much faster than GDP in the last two years and this has resulted in the current account deficit's reaching 10 per cent of GDP. In 1998, the main sources of growth are likely to be investment, spurred by the post-war rebuilding, and exports. Consumption is expected to decelerate due to a tighter monetary and fiscal policy as well as some moderation in wage growth. In 1997, the fourth consecutive year of increasing output, the economy of the **Federal Republic of Yugoslavia** grew by 7.5 per cent. GDP, however, was only about half the level reached in 1989. Growth was strongest in export-oriented branches of industry owing to the preferential government credit allocation system. The upward trend in industrial production continues in 1998. Despite the strong export performance, the current account deficit was more than 12 per cent of GDP in 1997. In the absence of sufficient external financing, this was not sustainable. Thus, despite a tight monetary policy to raise interest rates, the dinar fell by 82 per cent in March 1998. Exchange-rate considerations underlie the continued tight economic policy being pursued in the **former Yugoslav Republic of Macedonia**. This will have a dampening effect on growth. In **Bosnia and Herzegovina**, the post-war recovery will continue to be driven by reconstruction-related activities, financed with international donor aid.

In **Albania**, a four-year economic recovery was interrupted in 1997 when GDP fell by about 7 per cent. The cause was the widespread disorder and violence in the first half of the year that was sparked by the collapse of deposit-taking "pyramid schemes". Albania will continue for some time to depend on international assistance for its recovery, which is expected to be rather fast and strong. Indeed, significant progress has already been made in achieving economic stabilization and growth is returning.

The Baltic States of **Estonia, Latvia and Lithuania** are enjoying strong growth, underpinned by rapid industrial restructuring and a robust services sector. As in many other transition economies, increased demand for capital goods has led to large trade and current account deficits. The latter reached 10-15 per cent of the countries' GDP. Thus far, external imbalances are being easily financed by increasing inflows of foreign direct and portfolio investment, partly as a result of privatizations. For instance, foreign direct investment inflows jumped by 48 per cent in Latvia in 1997 and this trend is expected to continue. Import growth is likely to outstrip export growth for several more years until structural changes in industry lead to stronger export performance. Meanwhile, the rising surplus in services due to the increasing importance of the region in transit trade could help offset part of the trade deficit.

The developing economies

The developing economies maintained their growth momentum in 1997 for one more year, registering an average rate of growth of 5.8 per cent (see table II.3). There was substantial acceleration of growth in Latin America and strong expansion in Western Asia. Overall growth in Africa was impeded by weather-related factors in a number of countries, but economic expansion remained widespread. Economic growth in Eastern and Southern Asia and China slowed in the second half of the year, owing to the regional financial crisis and less growth in domestic demand, respectively.

Economic growth of the developing countries in 1998 is expected to be only 3 ¾ per cent, due primarily to direct and indirect consequences of the 1997-1998 Asian financial crisis. Contractionary adjustment policies, poor business confidence, shortage of domestic liquidity and scarcity of external finance underlie the economic contraction in the crisis countries in Asia. Restrictive macroeconomic policies adopted in a number of East Asian economies and some Latin American countries – in many cases a response to external financial pressure emanating from the crisis – and the higher cost of external financing will dampen economic growth. Reduced foreign direct investment flows from the affected Asian economies is expected to have a negative effect on those developing countries for which such financing is an important source of investment. Weaker international commodity prices, aggravated by significantly reduced demand from Asia, are anticipated to weaken economic growth in commodity exporting countries in Africa, Latin America and Western Asia.

Africa: growing, but too slowly

Africa's GDP per capita increased in 1997 for the second consecutive year, although only marginally.[11] Average output growth in 1997 slowed to 3 per cent from almost 4.5 per cent in 1996. Nevertheless, almost a quarter of the countries regularly monitored by the Department of Economic and Social Affairs of the United Nations Secretariat grew at least 6 per cent. Growth exceeded 7 per cent in Angola, Ethiopia and Rwanda – all countries that are trying to recover from steep economic declines – and in Botswana. However, slower growth in Morocco and South Africa, as well as in other countries such as Kenya, Malawi, Mauritius, Togo, Tunisia, Uganda, the United Republic of Tanzania, Zambia and Zimbabwe, contributed to the deceleration of growth in Africa as a whole.

Growth is forecast to strengthen slightly in 1998, but remain below 4 per cent (see table II.3), as weather-related difficulties in 1997 ease in most countries. However, Eastern Africa, where Ethiopia, Uganda and the United Republic of Tanzania suffered lower production of agricultural commodities in 1997 as a result of the heavy rains and flooding, will feel most of the impact of lower agricultural output in 1998. Uncertainty remains regarding the effects of the El Niño weather pattern and the financial crisis in Asia. Also, uncertainty surrounding the peace process in Angola and the transition to civilian rule in Nigeria could continue to discourage investment and output growth in those countries.

It appears that many countries in Africa have entered a period in which the trend rate of growth is higher than previously – perhaps between 5 and 6 per cent. Yet, poverty in Africa remains pervasive and unemployment high. Even countries that have benefited from a decade or more of rising GDP per capita (for example, Ghana and Uganda) have not yet recovered the GDP per capita levels of the 1970s. Indeed, at an average rate of growth of

[11] The discussion of economic trends in 1997 is based, in part, on *Economic Commission for Africa, Economic and Social Policy Division Economic Report on Africa, 1998* (United Nations publication, forthcoming).

GDP of 4 per cent a year (and with a population growth rate of 2.7 per cent) it will take another 13 years for Africa as a whole to recover the GDP per capita level of 1980. Moreover, Africa remains highly vulnerable to exogenous shocks, such as those related to weather or international commodity prices.

Vulnerabilities exposed in 1997

The two most significant factors behind the spurt in growth that was seen in 1996 – high oil prices and improved agricultural output – had largely evaporated by 1997, as oil prices declined and Northern, Eastern and Central Africa saw severe drought or heavy rains. The reduced agricultural output led to higher food prices and also necessitated higher food imports. There were budgetary consequences as well, as Governments subsidized food imports and lost revenues from the temporary elimination of taxes on food imports (in Kenya and the United Republic of Tanzania) and through the sale of food below market prices (in Zimbabwe).

Crops were below normal in most countries of Northern Africa, where the combined cereal production of Algeria, the Libyan Arab Jamahiriya, Morocco and Tunisia declined by 63 per cent. GDP fell 2.2 per cent in Morocco, for the fourth decline in the last six years, owing to drought. Drought in early 1997 was followed by heavy rains and flooding attributed to El Niño later in 1997 and in early 1998 in Ethiopia, Kenya, Uganda and the United Republic of Tanzania, causing widespread damage to food crops, livestock and infrastructure. After having achieved self-sufficiency and become a net food exporter in 1996, Ethiopia lost 25 per cent of its crops in 1997. Flooding caused extensive damage in Somalia and the Sudan. In South Africa and Zambia, output fell from the record high levels of 1996.

In Western Africa, cereal production was mixed because of a long dry-spell in the middle of 1997, harming crops in the Gambia, Mauritania and Senegal. A drought in Ghana has hurt particularly the production of hydroelectricity, which had a severe impact on industrial production in Ghana, as well as Benin and Togo. On the other hand, there were record cereal crop harvests in Benin, Nigeria and Togo, while Liberia's cereal output, benefiting from peace and good weather, was estimated to be 75 per cent higher in 1997 than in 1996.

Many fuel-exporting countries compensated for the fall in oil prices by increasing the volume of production. As a result, total export revenues were generally maintained at 1996 levels in almost all fuel exporters and GDP growth rates in 1997 were unchanged or somewhat lower in nearly all of them. In Nigeria, GDP grew by 3.8 per cent in 1997, half a percentage point more than in 1996, but economic activity there continued to be hampered by depressed domestic demand, frequent power failures and severe fuel shortages – caused by lack of maintenance of oil refineries – which pushed up transportation costs and crippled economic activity.

More generally, trade has had growth-increasing as well as growth-retarding effects. Strong demand in developed countries for Africa's exports, strong prices for several non-oil commodities in early 1997 and larger export volumes contributed to export growth. For example, South Africa registered steady growth in non-gold exports (7.4 per cent in 1997), boosted by a weak exchange rate and recent investments in capacity, particularly in the processing of minerals. This bolstered the economy and prevented slow growth from deteriorating into a recession. At the same time, the decline in gold prices since 1996 has made at least 12 gold mines unprofitable in South Africa, putting many more people, on top of the 50,000 laid off in 1997, at risk of losing their jobs.

Table II.3. Developing countries: rates of growth of GDP, 1991-1998
(Annual percentage change)

	1991-1997	1991	1992	1993	1994	1995	1996	1997[a]	1998[b]
Developing countries [c]	5.0	3.2	5.0	5.2	5.6	4.6	5.7	5.8	3¼
of which:									
Africa	1.7	0.8	-0.4	-0.6	2.0	2.7	4.5	3.0	3¾
Eastern and Southern Asia	7.6	6.9	7.8	7.9	8.6	8.2	7.5	6.5	3¾
Region excluding China	6.3	6.2	5.6	5.9	7.0	7.3	6.5	5.4	2
of which:									
East Asia	6.7	7.2	6.0	6.5	7.6	7.6	6.6	5.5	1
South Asia	4.8	2.9	4.2	3.9	5.2	6.2	6.0	5.1	5¼
Western Asia	2.6	-5.0	5.5	4.3	-0.9	4.1	4.8	5.9	4
Latin America and the Caribbean	3.4	3.4	2.9	3.5	5.5	-0.1	3.7	5.4	3¼
Memo items:									
Sub-Saharan Africa (excluding Nigeria and South Africa)	1.6	-0.3	-1.2	-3.0	1.7	4.1	5.3	4.8	4½
Least developed countries	2.2	-0.5	0.6	-1.2	1.8	4.6	5.0	4.9	4¼

Source: United Nations.

a Preliminary estimates.
b Forecast, based in part on Project LINK.
c Covering countries that account for 98 per cent of the population of all developing countries. For additional country detail, see table A.4.

In addition, political insecurity or outright civil strife hindered economic activity in several countries, such as Angola, Burundi, the Congo, the Democratic Republic of the Congo (formerly Zaire), Kenya, Nigeria, Sierra Leone, Uganda and Zimbabwe. Economic recovery in Angola continued to be hampered by slow progress in the peace process; the expansion of offshore oil production provided the only source of growth in 1997. In Sierra Leone, the social and economic situation deteriorated sharply following the *coup d'état* that removed the democratically elected president from power in May 1997. Although he was reinstated in early 1998, economic recovery will be severely hampered by extensive damage to infrastructure. After a seven-year civil war in Liberia, a recovery of economic activity could be discerned in 1997 and early 1998. There are also hopeful signs that years of economic decline in the Democratic Republic of the Congo will be reversed as the new Government has entered the first stages of its economic stabilization and reconstruction programme, which will give a large role to the private sector in the development of infrastructure, agriculture and mining.

Scattered dynamism

Despite continued volatility in growth and vulnerability to exogenous shocks, there are certain manifestations of dynamism that can be discerned in some countries. One is the rapid increase in non-traditional exports in a number of countries; another indication of nascent dynamism is stronger investment. Some countries, for example, Botswana, Ghana and Zambia, continued to benefit in 1997 from larger non-traditional exports, partly compensating for lower volumes of, or prices for, traditional exports. Export revenues from non-traditional exports increased by 34 per cent in Zambia in 1997. Several countries, for example, Egypt, the Gambia, Madagascar, Mauritius, South Africa, Tunisia, and the United Republic of Tanzania, benefited from higher tourism revenues. Tourism is increasingly seen as an important source of foreign exchange earnings and employment creation by several African countries. Ghana and Namibia, for example, recently formulated plans to expand the tourism sector. Tourism is, however, also highly sensitive to income growth in countries that are sources of tourists and to domestic strife and regional conflict in tourist-receiving countries, as recent events in Egypt and Kenya demonstrated. Tourism revenues reached a record in Egypt in 1997, but arrivals of tourists were down sharply by year-end after an attack by terrorists on tourists in Luxor in November 1997. A decline of $600 million to $800 million in tourism revenues is expected for the 1997/98 season. Kenya also suffered a decline in tourism after riots in the main tourist area in August and September 1997, leading to a loss in tourism revenues of an estimated $280 million between mid-1997 and mid-1998, equivalent to more than half of total tourism revenues in 1996.

Another dimension of non-traditional exports is expansion of trade among non-traditional partners. For example, GDP of the Southern African Development Community (SADC) – excluding South Africa (as well as the Democratic Republic of the Congo and Seychelles both of which joined in 1997) – grew 5 per cent in 1997, largely under the impetus of the strong growth of South African trade and investment in the region and flourishing trade among the members of the Community.

Domestic investment, as well as slightly improved inflows of foreign direct investment, was an important contributor to GDP growth in some countries in 1997, such as Côte d'Ivoire, Egypt, Ethiopia, Mozambique, South Africa and Uganda. Investment has responded to macroeconomic and political stability, economic reforms and higher economic growth. Foreign investment also took advantage of opportunities created by steadily expanding privatization programmes in many countries. In Egypt, for example, capital inflows, privatization and liberalization of investment regulations have recently stimulated

investment, particularly in construction and tourism but also in car manufacturing. Asian foreign direct investment in Africa has increased rapidly in the 1990s: foreign direct investment from five Asian countries amounted to at least $541 million between 1990 and 1996.[12] Some major direct investments from Asia were announced in 1997, but the regional financial crisis might put some of these plans in jeopardy.[13]

Inflation and policy reform

Strict monetary and fiscal policies have sharply curtailed inflation in Africa (see table A.13). In Angola and the Democratic Republic of the Congo, quadruple-digit inflation rates were reduced to double digits. In Ghana, the inflation rate continued to decline during 1997, but remained rather high at 28 per cent for the year owing to exchange-rate depreciation and rising energy prices. Inflation in Nigeria has decelerated drastically since 1995, reaching only 8 per cent in 1997 as a result of tight monetary and fiscal policies and a stable exchange rate. Inflation rates also continued to decrease in most countries in the franc zone (except for the Central African Republic, the Congo, Côte d'Ivoire and Togo) and were at the single-digit level in all but two countries (the Congo and Guinea-Bissau). The inflation rate also fell in Morocco in 1997 despite higher food prices. In Algeria, Botswana, Egypt, Namibia, South Africa and Zambia, lower inflation rates allowed an easing of monetary policy via lower interest rates. For example, the inflation rate fell in South Africa to 5.4 per cent in February 1998 from an average 8.6 per cent in 1997 and the key interest rate was reduced by two percentage points by March 1998, as capital inflows recovered as well. Lower inflation in South Africa led to lower import prices and inflation rates in countries heavily dependent on imports from South Africa, such as Botswana and Namibia.

However, inflation accelerated in a number of countries that suffered from higher food prices. In Ethiopia, Kenya and Uganda, which had been successful in reducing inflation in recent years, food prices increased in early 1998 as food shortages developed. Inflation continued to be rather high in Burundi – where economic sanctions and a transportation boycott by neighbouring countries led to widespread scarcities of consumer and other goods. Exchange-rate depreciations contributed to higher inflation in Madagascar, Malawi, Uganda and Zimbabwe and wage increases led to inflationary pressures in countries such as Benin and Zimbabwe.

Despite such setbacks, African countries generally continued to adhere to strict monetary and fiscal policies to improve macroeconomic balance. Liberalization and structural reforms also continued in many countries. Financial sector reforms, building on macroeconomic stability, deepened in several countries. For example, new central bank legislation, which gives the central bank greater autonomy and secures the tenure of the Governor, was adopted in Kenya; and the banking sectors were restructured in Mozambique, the United Republic of Tanzania and Zimbabwe. Privatization of State-owned enterprises has continued at a steady pace in Cape Verde, Côte d'Ivoire, Egypt, Morocco, Mozambique, Senegal, South Africa, Tunisia, Uganda and Zambia and new privatization programmes have recently been initiated in Botswana, Eritrea and Lesotho, while Algeria and Zimbabwe realized their first privatization of a State company in 1997. Egypt further liberalized trade and investment regulations in 1997 and a new investment law was passed. This law offers, *inter alia*, a number of tax incentives, protection of property rights, freedom of money transfers and the end of a negative list and the licensing requirement

[12] *World Investment Report, 1997: Transnational Corporations, Market Structure and Competition Policy* (United Nations publication, Sales No. E.97.II.D.10), box 11.5.

[13] For example, a bank from Malaysia that bought part of a privatized Ugandan bank was granted a payment extension after the financial crisis hit Malaysia.

for new investment. Other countries that took specific measures to promote investment included Algeria, Gabon, South Africa and the United Republic of Tanzania.

Uncontrollable factors in the outlook

It was feared last year that the El Niño weather pattern would have a disastrous impact on agriculture in Southern Africa in particular, but on Western Africa as well. The outlook for the 1997/98 crop season is still uncertain but as of early 1998, the conditions have been generally favourable and the worst fears have not been borne out. For several countries in Southern Africa, the cereal crop is forecast to be smaller in 1998 (by 13 per cent in South Africa and Zimbabwe), but this is partly a result of a reduction in acreage planted as farmers were warned of the likelihood of a severe drought.[14]

Growth prospects will also be adversely affected in 1998 by lower demand for exports, lower commodity prices and greater competition from Asian exporters as a result of the financial crisis. A sharp slowdown of economic activity in several Asian countries, some of which became the fastest-growing trading partners for a number of African countries in recent years, is expected to dampen exports.

The financial crisis in Asia is in part reinforcing a downward trend in oil and commodity prices that started for some commodities in 1996, but has accelerated since the second half of 1997. For example, the fall in copper prices during 1997 has severely damaged Zambia's growth prospects, not least because a number of negotiations on the privatization of copper mines broke down. Moreover, lower oil prices are negatively affecting government and export revenues in 1998 of fuel-exporting countries such as Algeria, Angola and Nigeria. In early 1998, some tentative signs that the growth of exports was falling as a result of the financial crisis in Asia also became apparent, particularly in South Africa.

The contagion effect of the Asian crisis on financial flows to Africa was largely restricted to South Africa, where the effect was limited by the healthy macroeconomic and financial sector indicators and by the fact that South Africa had already had an exchange-rate correction in 1996. However, direct investment from Asia is likely to be smaller as the main investors (Malaysia and the Republic of Korea) scale back their investment plans.

Asia and the Pacific

East Asia: fallout of a financial crisis

East Asia underwent its most devastating economic shock in the second half of 1997, which was still reverberating in early 1998. Still, economic growth in East Asia in 1997 averaged 5.5 per cent, only slightly lower than the 1996 figure of 6.6 per cent.[15] However, this was largely because of strong economic growth in the first half of the year. Economic performance statistics are expected to deteriorate markedly in 1998, with the average growth rate for the subregion forecast to plunge to only 1 per cent (see table II.3).

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[14] Indeed, the SADC Regional Early Warning Unit issued its first warning in June 1997, giving Governments, donors and farmers time to switch to more drought-resistant crops, change planting patterns, retain cereal surpluses and manage water more carefully (see Ernest Harsch, "Africa braces for El Niño's impact: preparing against drought in southern Africa", *Africa Recovery*, vol. 11, No. 3 (February 1998), pp. 1 and 12-13.

[15] The discussions of 1997 economic trends in East Asia, China and South Asia have drawn in part on *Economic and Social Survey of Asia and the Pacific, 1998* (United Nations publication, Sales No. E.98.II.F.59).

In a sense, even this outlook is "optimistic". It assumes continued financial stabilization in the region, progress in adjustment and debt rescheduling, particularly in Indonesia, and an unchanged exchange rate in China. In addition, the Japanese economy is not expected to fall deeper into recession during the remainder of the year. If these expectations prove false, output in the region might indeed be weaker in 1998.

For East Asian developing countries, the heart of the crisis has been financial. In the most afflicted countries (Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand), real effective exchange rates depreciated by figures within the range of about 30 to 65 per cent (see figure II.2) between June 1997 and January 1998. Stock market indices declined by 30 to 50 per cent. The fact that the underlying economic situations did not warrant "corrections" of such a magnitude underlines how much the East Asian crisis had been driven by a loss of investor confidence.

A strengthening of the financial indicators in most of the countries during the first quarter of 1998 was therefore received with a sigh of relief. Indeed, in early April, with strong investor demand, the Government of the Republic of Korea sold $4 billion worth of bonds on the international market with maturities of 5 and 10 years. In early 1998's most uncertain case, that of Indonesia, market sentiment also improved in April, after a new adjustment agreement was concluded with the International Monetary Fund (IMF).

The downward spiral of currency depreciation and stock market decline starting in mid-1997 undermined the viability of heavily indebted financial institutions and corporations, drying up liquidity and freezing investment and even production. Together with significantly higher interest rates throughout the region to shore up exchange rates, there began a flood of bankruptcies of heavily indebted, but otherwise viable, corporations, which further weakened local financial institutions.

Because of contagion in financial markets, strong intraregional trade and financial linkages and, in some cases, competition of exports in third markets, even the economies with much smaller imbalances, sustainable debt levels and relatively sound financial and corporate structures have been adversely impacted. Nevertheless, in those economies – including Hong Kong, China; the Philippines; Singapore; and Taiwan Province of China – the consequences have been less severe.

Differences between individual economies in the nature and intensity of the adjustment and reform processes have become increasingly marked. Problems have been most severe in Indonesia, the Republic of Korea and Thailand. Economic activity is expected to contract in 1998 by 1 to 4 per cent in these countries (see table II.4). Malaysia suffers from similar if less intense problems of high domestic indebtedness and financial sector weakness, requiring adjustments that are expected to depress the rate of economic growth to only 2 per cent in 1998. Growth will slow to 2½ per cent in the Philippines and to within a range of 3½ to 6 per cent in Hong Kong, China; Singapore; and Taiwan Province of China.

Domestic demand in all the East Asian economies had weakened by late 1997, although the downturn took hold in Thailand around the middle of the year. In Indonesia, the Republic of Korea and Thailand, high interest rates and heavy corporate debt burdens caused a sharp contraction of investment, which is expected to persist in 1998. Consumption will continue to be weak as well because of the spillover from rising unemployment, accelerating inflation and, to some extent, the decline in the price of real and financial assets. Investment and consumption will also be depressed in Malaysia, but to a lesser extent. In Hong Kong, China, and in Singapore, investment and consumption

are expected to remain weak in 1998 because of still high interest rates, depressed asset prices and weaker employment and wage prospects.

The expected boost to export growth from currency depreciation had not materialized as of early 1998 in Indonesia, Malaysia and Thailand, while there appeared to be some encouraging signs in the Republic of Korea. The major impediment to responding to the price incentive from the lower exchange rate has been the lack of domestic working capital and external credit for import of necessary inputs, because of the financial crisis. In addition, the increase in cost of imported inputs and the concurrent depreciation in competitor countries in the region have partly offset the favourable price effect of the currency depreciations. Furthermore, the economic slowdown in Japan, a major market for East Asian exports, dampened export demand. Export growth of Hong Kong, China, of Singapore and of Taiwan Province of China is also expected to decelerate because of weakness in intraregional exports.

The contraction of economic activity has been associated with the severe compression of imports, primarily of capital goods and inputs. The stagnation of investment has been a major factor in the reduced demand for imported intermediate goods, while the drying up of credit for imports is another factor. In Indonesia, the Republic of Korea, the Philippines, Malaysia and Thailand, current account deficits contracted sharply in the latter part of 1997. They are expected to move into surplus in the Republic of Korea and Thailand in 1998.

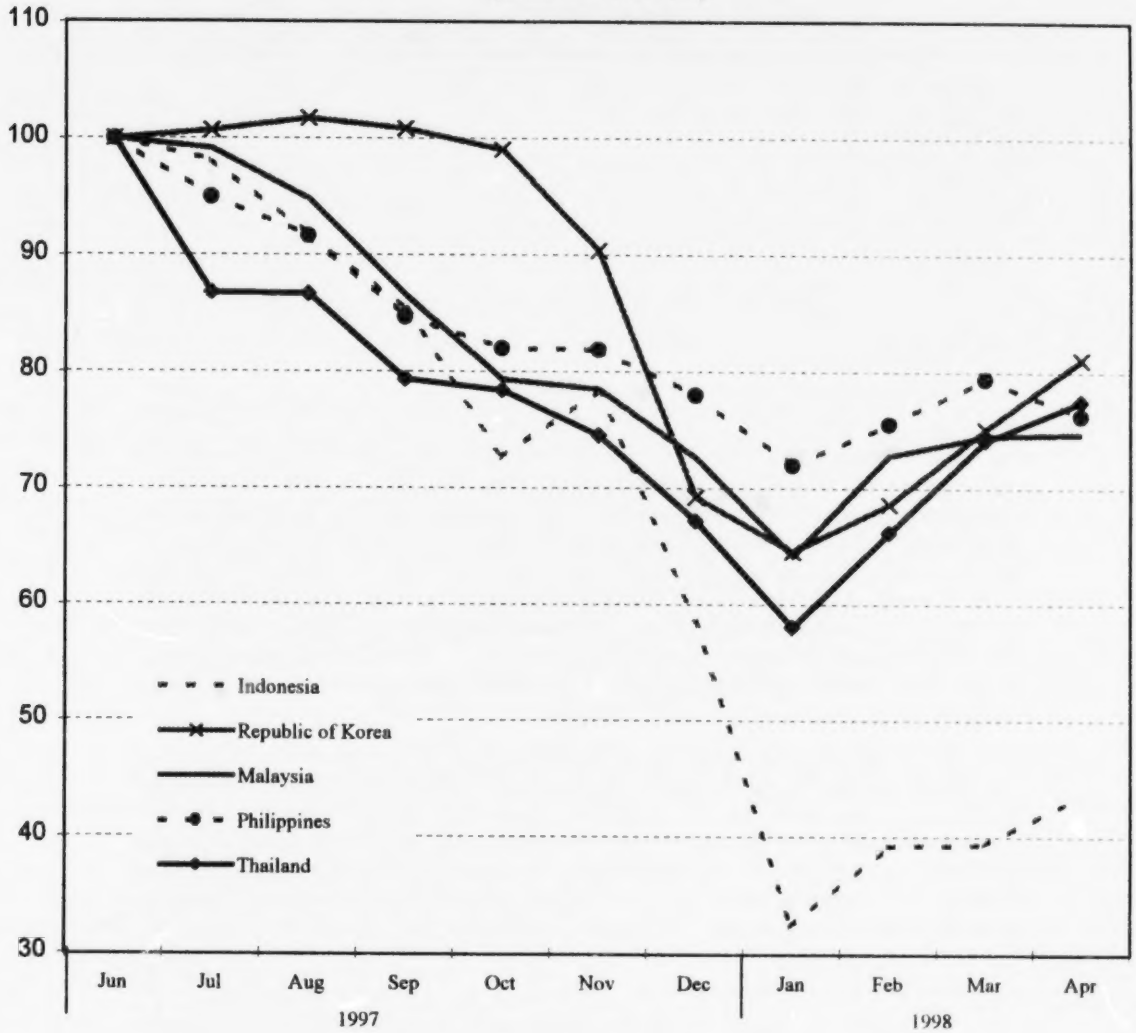
As the large currency depreciations filtered through to the prices of imported foods, energy and other basic raw materials, the prices of staples have risen sharply. In Indonesia, a drought induced by the El Niño weather pattern has cut back domestic harvests and aggravated the rise in food prices. Outlays on food subsidies have soared accordingly, generating heavy pressure on the government budget. For the rest of the year, more stable exchange rates and better weather and distribution conditions are expected to mitigate conditions. Nevertheless, overall inflation in 1998 is expected to soar to 40 per cent in Indonesia, and will accelerate as well in the Republic of Korea, the Philippines and Thailand to within a range of 9 to 13 per cent (see table II.4).

The more rapid inflation will partly offset the price stimulus for expanded export production from the devaluations. However, in response to the contraction in demand for labour since late 1997, wage pressures in Thailand and Malaysia have eased, improving prospects for cost competitiveness. In the Republic of Korea, average real wages declined in the fourth quarter of 1997. With an increase in the incidence of wage reductions or wage freezes in the first few months of 1998, real wage reduction can be expected to continue during the year.[16]

[16] International Labour Organization, "The social impact of the Asian financial crisis" (technical report for discussion at the High-Level Tripartite Meeting on Social Responses to the Financial Crisis in East and South-East Asian Countries, Bangkok, Thailand, 22-24 April 1998), pp. 22-23.

Figure II.2. Real effective exchange rates of selected Asian countries June 1997 to April 1998

(Index: June 1997=100)



Source: Morgan Guaranty Trust Company, *World Financial Markets*.

Table II.4. Selected macroeconomic indicators for Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand, 1996-1998

	GDP growth rate			*Current account balance*			*Inflation*			*Unemployment*		
	(percentage)			*(percentage of GDP)*			*(percentage)*			*(percentage)*		
	1996	*1997[a]*	*1998[b]*	*1996*	*1997[a]*	*1998[b]*	*1996*	*1997[a]*	*1998[b]*	*1996*	*1997[a]*	*1998[b]*
Indonesia	8.0	6.6	-4	-3.5	-2.3	-1	8.0	6.6	40	4.5	4.8	9
Republic of Korea	7.1	5.5	-1	-4.9	-1.7	4	4.9	4.4	9¾	2.0	2.6	6
Malaysia	8.2	7.0	2	-5.0	-5.1	-2	3.5	2.7	7	2.6	2.7	4
Philippines	5.5	5.1	2½	-4.7	-4.0	-3	8.4	5.5	9	7.5	8.7	9½
Thailand	6.7	0.4	-3	-7.9	-3.3	4	5.9	5.6	13	2.6	4.5	8½

Source: Department of Economic and Social Affairs of the United Nations Secretariat.

[a] Estimate.

[b] Forecast, based in part on Project LINK.

Unemployment, however, has been rising sharply in a number of countries and is expected to worsen in 1998 from waves of lay-offs owing to corporate and financial retrenchment, impacting both skilled and unskilled workers (see table II.4). In the Republic of Korea and Thailand, where unemployment rates of under 3 per cent were the norm prior to the crisis, they are expected to jump to 6 per cent and over 8 per cent, respectively, in 1998. The number of unemployed in Indonesia is expected to reach 8 million to 9 million in 1998, raising unemployment to 9 per cent. Open unemployment could reach 9 to 10 per cent in the Philippines. In Hong Kong, China, as well, the number of unemployed jumped in early 1998. The average unemployment rate in 1998 is expected to be about 3½ per cent, compared with an average of about 2.5 per cent in 1997.

Rising unemployment has forced the repatriation of foreign workers from some of these countries (for example, Malaysia, Singapore and Thailand). There are also serious concerns about the social situation, as the loss of wages and sharply higher inflation have substantially reduced the standard of living of wide segments of the population and pushed large numbers into poverty. The International Labour Organization estimates that the number of people falling below the Government's poverty line in Indonesia in 1998 could increase substantially from the 22.5 million in 1996.[17]

The struggle to restore stability

The East Asian crisis revealed unsustainable external imbalances, excessive indebtedness, especially in terms of short-term obligations of the private sector, and serious structural weaknesses in the financial and corporate sectors of a number of countries. Between July 1997 and April 1998, Governments thus adopted a series of sharp adjustment measures, supported by commitments of massive international financial assistance under the leadership of IMF. These assistance programmes emphasized austere monetary and fiscal policies, financial sector consolidation and structural reform. Malaysia also suffered from high private indebtedness and weaknesses in financial institutions, although its

[17] Ibid., p. 25.

external indebtedness was relatively low. It adopted domestically formulated macroeconomic policies and strong financial reform measures in response.

Macroeconomic policy response. Interest rates were sharply higher in the second half of 1997 in the main economies of the region, as Governments defended their weakened exchange rates in the face of bouts of speculative pressure. Monetary policy in 1998 is expected to remain restrictive in the face of remaining financial uncertainties and the need to contain the inflationary pressure from the large currency depreciations, although some moderation is expected as the year unfolds.

However, interest rates were almost doubled in Indonesia in March 1998 to bolster the exchange rate and restrain inflation. Malaysia also raised interest rates sharply in March as part of its new package of economic adjustment policies. Interest rates were reduced in the Republic of Korea, on the other hand, as the exchange rate stabilized in response to successful debt restructuring (discussed below). Also, in Hong Kong, China, and in Singapore, rates were lowered as regional financial conditions stabilized. Some easing is also expected in Thailand where there is progress in macroeconomic adjustment and financial reform and where the exchange rate has been recovering from recent lows.

Fiscal policy in the region was tightened significantly after the onset of the financial crisis and is expected to remain restrictive. One reason was the anticipated need for resources to help recapitalize fragile financial institutions, a potentially serious drain on fiscal resources in these countries. A second reason, in countries with unsustainable deficits in their balance of payments on current account, was to curtail imports through a reduction in aggregate spending (as in Thailand).

Thus, as tax revenues shrank with the deterioration of economic conditions, expenditures were cut to prevent the growth of fiscal deficits. Thailand raised taxes on specific products and has planned a privatization programme for 1998 which will help to shore up revenues. Sharp reductions in government expenditures have been budgeted in Thailand and Malaysia, with cutbacks of large investment projects, and a smaller consolidation is budgeted for Indonesia. In the Republic of Korea, substantial scaling back of defence and investment expenditures is budgeted.

However, in the light of the deeper-than-expected fall in economic activity, rising unemployment and rising economic hardship, fiscal targets were eased in Indonesia, the Republic of Korea and Thailand to relax pressure on social expenditure. Indonesia, for example, in its April agreement with IMF, will maintain subsidies on staple foods whose prices have soared owing to currency depreciation and drought. In the Republic of Korea, large increases are budgeted for unemployment benefits and the growth of education expenditures has been maintained. In the Philippines, government expenditures have risen somewhat, while higher interest rates have made debt-servicing outlays soar. In Hong Kong, China, and in Singapore, fiscal balances are expected to ease somewhat to allow automatic stabilizers to mitigate the adverse effects of the regional economic slowdown.

Addressing the private-sector debt crisis. In many senses, the essence of the East Asian crisis was the vulnerability of highly leveraged corporations and poorly managed financial institutions to a sudden increase in debt-servicing obligations. Higher domestic interest rates and currency depreciations were precisely the shocks they could not withstand. Thus, the reducing of short-term debt-servicing obligations through negotiated debt restructuring and refinancing of debt maturities, and policies to evaluate bad debt and move it off the books of financial institutions have been essential features of the work out from the crisis, as have policies for restructuring and reform of the financial and corporate sectors.

As of March 1998, the Republic of Korea had obtained significant results in the restructuring of private external debt. The Government of Korea has played a central role in successfully negotiating with the major international creditor banks the conversion of 95 per cent ($21.6 billion) of short-term debt to medium-term debt (one to three years maturity), effective April 1998. As a result, the country's external debt structure improved significantly, with the share of short-term debt falling to 30 per cent from the earlier 44 per cent.

Thai banks have been rolling over their short-term debt on a bilateral basis. Stronger institutions have been able to raise capital through the sale of equity, including to foreign investors. The Government has facilitated the sale of assets or debt-for-equity swaps of troubled banks as a means to pay off outstanding debt. In Indonesia, efforts at resolving the external overhang of corporations and banks were just beginning in April.

Domestic private debt has also required policy attention. In the Republic of Korea, it caused a sharp increase in corporate bankruptcies in 1997. Thus, the Government of Korea is considering measures to reduce the $421 billion domestic private debt. The intention is to provide some financial breathing room for basically sound companies suffering a short-term credit shortage and to facilitate restructuring of corporations and bad debts of financial institutions. The Government does not intend to offer unlimited bailouts and unsalvageable financial institutions will be merged or sold. A publicly financed equity fund will purchase shares in troubled companies, buy up short-term debt of companies and convert it into long-term debt, and buy up real estate from troubled companies to help them restructure. In addition, financing will be increased for an existing debt restructuring fund set up to buy bad loans from banks.

With regard to restructuring financial institutions and corporations, as well as strengthening financial regulation and supervision, significant policy changes have been implemented in the Republic of Korea and Thailand, but much remains to be done. Closures, takeovers and sales of insolvent financial institutions have been undertaken in both countries. Stricter financial regulations, such as bad loan classifications and provisioning rules, have been introduced. More liberal foreign investment laws in direct and portfolio investment have been passed to increase capital inflow, including for recapitalization of banks and debt reduction of corporations. In the Republic of Korea, the easy access to credit of loss-making conglomerates has ended, raising pressure for restructuring. In addition, legislation has also been passed to strengthen the financial supervisory structure, as well as the autonomy of the central bank. In Thailand, the bankruptcy law was amended to facilitate creditor access to debtor assets.

In Indonesia, a bank restructuring agency was created, capital requirements were raised and restrictions on foreign ownership of banks were eased. A large number of insolvent banks, taken over by a newly established restructuring agency, are targeted for liquidation if the owners cannot mobilize new capital. Fourteen banks were taken over or suspended in April. The weak legal system for bankruptcy proceedings is being strengthened. The new agreement with IMF in April pushes for more expeditious implementation of financial restructuring and reform.

In Malaysia, a large number of weak financial institutions have been merged with a small number of strong ones to absorb the burden of non-performing loans. At the same time, stricter financial requirements are applied in loan classification and provisioning. Limits on foreign ownership of financial institutions (30 per cent) remain and constrain foreign investment in troubled banks.

China: deepening reforms while weathering a regional crisis

Economic growth in China slowed in 1997, but was still almost 9 per cent, as the country continued its "soft-landing" strategy of reducing inflation without delivering a major shock to economic growth. However, towards the end of the year, concern shifted as it began to look as though the slowdown might become excessive. Monetary policy was thus relaxed in the second half of 1997 and interest rates were cut in October in order to strengthen economic growth. The outlook for 1998 is thus somewhat uncertain.

A relatively tight macroeconomic policy stance had been maintained through the first half of 1997. This helped to contain growth in fixed investment – the main culprit for economic overheating in the past – which expanded by about 10 per cent in 1997 (down from 18 per cent in 1996). Growth in consumer demand also slowed down: total retail sales of consumer goods grew about 11 per cent in 1997, 8 percentage points lower than in 1996, as a result of the slower income growth and rising unemployment, as SOEs shed excess workers.

The softening of growth in consumption, combined with a slow pace of restructuring in the State sector, exacerbated losses incurred by SOEs, as inventories of unsold goods rose. Losses by SOEs reached about 10 per cent of GDP in 1997. State-owned enterprises continued to lag behind the non-State industrial sector in growth rates of output, exemplifying a trend that has been maintained since the mid-1980s; but growth also decelerated in the non-State sector in 1997, owing to slowing demand and, probably, a need for small and medium-sized collective and private enterprises to upgrade their management and technology.

Weakening domestic demand was counterbalanced by strong external demand. Exports grew almost 21 per cent in 1997, rebounding from the slowdown of 1996, while imports increased by only 2.5 per cent. Foreign capital continued to flow into China, at a volume of about $64 billion in 1997, of which about $45 billion were foreign direct investments. However, the value of foreign investment contracts, an indicator of future inflow, was 24 per cent lower in 1997 than in 1996. This contraction resulted partly from a pause after several years of rapid growth, uncertainty in the aftermath of the Asian financial crisis and the cutback in investment from other Asian economies.

Inflation continued to moderate as a result of the slower growth of domestic demand, aided by the effect of good harvests on prices. Consequently, the rate of inflation in 1997, 2.8 per cent, was the lowest since 1985.[18]

How much growth in 1998?

Prospects for 1998 are for further moderation in economic growth, although there is some uncertainty over the extent of the deceleration. The Government has relaxed monetary policy further by cutting interest rates and lowering the required reserve ratio in March, while increasing public spending in support of infrastructure development.

The fallout from the Asian financial crisis is expected to slow China's export growth significantly in 1998. Economic contraction in crisis-afflicted countries and economic slowdown in others will reduce demand for China's exports. Some of China's exports will be undercut somewhat by the sharp devaluations by its Asian competitors, despite which

[18] The consumer price index, the most commonly used gauge of inflation, was not compiled by China until 1985. Previously, China measured the rate of inflation using the overall retail price index, which it continues to publish. In terms of this index, inflation was only 0.8 per cent in 1997, the lowest rate since 1979.

China is expected to maintain its exchange-rate peg (see box III.1). China's export expansion is thus forecast to slow down to a growth rate of about 7-8 per cent in volume. Import growth, on the other hand, is expected to accelerate as a result of trade liberalization (see table A.18).

The impetus for growth is therefore expected to be mostly domestic, bolstered by the more expansionary macroeconomic policies. Investment demand is expected to strengthen somewhat in 1998, resulting from increases in public investment and monetary easing's stimulation of enterprise investment. However, plans to cut the country's civil service by half and to restructure loss-making SOEs are expected to dampen the growth of personal income and raise uncertainty about employment, and this could lead to more than proportionate cutbacks in consumption.

The net effect of these tendencies is that output is forecast to grow by about 8 per cent. There is considerable uncertainty in this outlook, however, mainly owing to uncertainty over the size of the slowdown in the growth of consumer demand noted above. Macroeconomic policy will aim, however, to maintain a sufficiently high rate of economic growth so as to generate sufficient jobs to absorb a significant portion of the unemployed workers.

Deepening economic reform

The Chinese yuan renminbi largely escaped the contagion effect of the Asian financial crisis during 1997, thanks to a sizeable foreign exchange reserve (over $140 billion at the end of 1997) and controls over the capital account. The Asian crisis nevertheless highlighted the urgency of economic reform, in particular regarding the development of the financial and enterprise sectors and market institutions in China. Indeed, the Chinese Government announced major reform policies in 1997. The Fifteenth National Congress of the Communist Party of China adopted a plan in September 1997 to restructure the vast SOE sector in order to eradicate the root cause of China's problem of non-performing loans. In the next three years (1998-2000), loss-making enterprises will be closed down or merged into profitable ones, or firms that are deemed inherently viable but sinking under an unsupportable debt burden may receive a measure of debt relief. The coverage of the experiment, ongoing since 1991, whose aim is to convert SOEs into joint stock companies was broadened, as both the number of firms and cities under the scheme doubled. In addition, plans were announced in early 1998 to reform the civil service by merging the 40 government ministries into 2[illegible] new ones and by reducing staff by half, or by 4 million persons.

Financial sector reform progressed as well, with measures to boost the independence of the central bank and develop a market-oriented commercial banking sector. These measures included the administrative streamlining of regional centres of the central bank to reduce the political influence of local governments on the operations of branches of the central bank. Also, top-down credit quota allocation was replaced with guidelines for capital-to-loan ratios and regulations governing prudential supervision of commercial banks. These measures are intended to increase operational autonomy in the banking sector while strengthening bank supervision. In addition, a $32 billion bond issue will be floated for the purpose of recapitalizing State-owned commercial banks, whose books are burdened with large amounts of non-performing loans.

The adoption of a public – in contrast to an enterprise-based – social safety-net is necessary to mitigate the impact of unemployment resulting from large-scale SOE restructuring. China is thus gradually expanding city-based experimentation in public pension funds and health and unemployment insurance schemes. Although these welfare

reforms lessen the financial burden on enterprises, which used to provide such benefits, they do require support from the government budget, which may call for tax increases. The concurrent implementation of these major reforms will be more challenging as economic growth decelerates.

Accelerated housing reform is envisioned by the Government as a means of stimulating domestic demand in the near term. Although commercialization of housing has been carried out on an experimental basis in some cities, housing subsidies for employees are still a major responsibility of SOEs and government offices. The elimination of such subsidies and the commercialization of residential housing will free up public resources, thus lessening the financial burdens of SOEs and the pressure on the public budget. Conversion to private ownership of housing will also stimulate investments in renovations and expenditures on household appliances. Moreover, through backward and forward linkages of additional residential construction, new growth momentum can be generated in the medium term.

South Asia: where stronger growth is attainable

South Asia has been relatively unscathed by the fallout of the Asian financial crisis. However, economic growth moderated in 1997 for other reasons. The main impact of the East Asian crisis on South Asia in 1998 is expected to be increased competition from labour-intensive exports of East Asian countries which have sharply depreciated currencies and, in Bangladesh, lower remittances of overseas workers.

In **India**, economic growth slowed to 5.4 per cent in 1997, owing to a fall in agricultural output and a weakening in industrial growth. After a number of years of favourable weather conditions, there was a reversal in 1997, resulting in losses in agricultural production. Poor agricultural performance had a knock-on effect on industrial production through lower rural incomes and demand, as well as weakness in agro-processing industries. Continued reduction in public investment since the economic reform process began in 1991 also had a dampening effect on industrial production. In addition, private investment was also subdued because of weak domestic demand and slow growth of exports.

Economic growth is expected to be maintained at a rate of 5½ per cent in 1998. Agricultural production will still be subdued owing to a disappointing harvest; but political uncertainty has been reduced with the formation of the new Government, and business confidence has improved with the affirmation by the Government that it would go on with the reform process and continue to maintain a favourable environment for foreign investment in infrastructure. In an attempt to boost economic activity, interest rate hikes in January to stem the depreciation of the exchange rate have been reversed. However, the possibility of fiscal tightening and the limit to monetary easing because of a larger-than-expected fiscal deficit (6.1 per cent of GDP compared with a target of 4.5 per cent) have raised concerns of private investors.

There could be some strengthening of external demand in 1998 which would provide a certain inducement to private investment. The depreciation of the currency in late 1997 is expected to result in some improvement in export growth. Its magnitude, however, will be limited by a slowdown in world demand, higher prices of imported inputs and depreciations in competitor countries in East Asia.

Inflation declined during 1997, but is expected to accelerate in 1998. The large fiscal deficit is the main factor in higher inflation. A poor crop harvest is also expected to push up food prices, while a weaker currency will raise domestic prices of imported goods.

There is likely to be some improvement in economic growth in **Pakistan** in 1998, with output rising to 4 per cent as compared with 3.4 per cent in 1997. The industrial sector should benefit from some supply side measures – tax and tariff reductions and investment incentives – introduced in 1997. A more stable political environment (the Government has a large majority in parliament) and financial backing from IMF for the Government's reform policies are also factors that should boost business confidence.

Against this, however, the economy suffers from serious structural problems on the fiscal and trade fronts. The fiscal deficit is likely to remain at about 6 per cent of GDP in 1998, as there has been a sharp fall in tax revenues owing to tax cuts. Monetary policy will be somewhat restrictive because of the need to hold down inflation. Inflation is expected to average just under 10 per cent. The large current account deficit has been falling, reflecting falling imports as a result of sluggish domestic demand, but is still expected to be 5 per cent of GDP this year. Despite the rupee's devaluation in late 1997, the increase in exports will be limited by slower world trade growth this year and intensified competition from other Asian countries in textile products.

Economic growth in **Bangladesh** is expected to moderate slightly to about 5 per cent in 1998 from 5.7 per cent in 1997. Industrial activity will, however, be supported by increased foreign investment in the power sector and in the oil and gas industries and by some easing in credit to the private sector. Inflation is expected to accelerate somewhat, as the pay award to public sector workers and disappointing rice production push up prices.

Export growth has been robust, and driven by a surge in garment sales, which account for a significant proportion of Bangladesh's exports. However, this strengthening in exports will be limited in 1998 by the massive currency depreciations of Bangladesh's major Asian competitors. Remittances from overseas workers are also likely to be reduced by sharply deteriorating employment conditions in East Asian countries. Meanwhile, import growth is likely to pick up owing to higher imports of capital goods for oil and gas exploration. There will consequently be some widening in the current account deficit in 1998.

Western Asia: oil price slide causes economic reversal

Economic growth in Western Asia accelerated in 1997, reflecting a marked expansion in private sector investment, as well as a significant increase in Iraq's output as a result of the partial resumption of oil exports.[19] The substantial increase in oil revenues, resulting from the sharp rise in oil prices in 1996, produced a favourable climate for economic growth in 1997. The windfall filtered through the economy and helped ease fiscal and external imbalances. The region's GDP is thus estimated to have expanded by about 6 per cent in 1997, compared with 4.8 per cent in 1996. However, disappointments in the Middle East peace process continued to hinder economic growth in the most directly affected economies, as they constrained intraregional flows of trade and investment among Israel, Jordan and the Palestinian self-rule area.

The outlook for Western Asia in 1998 is that growth will slow to 4 per cent, owing to the sharp decline in oil prices. Oil prices lost over one third of their value in the first quarter of 1998, compared with the same period last year, as a result of growing global supplies amid weak growth in world oil demand (see chap. III). With prices likely to stay low for the remainder of the year, the region's export revenues from oil in 1998 could drop by one fourth. By the same token, the oil-importing countries of the region are to receive a windfall from the lower price of their oil imports. However, the growth of their economies

[19] The discussion of economic trends in 1997 is based, in part, on *Survey of Economic and Social Developments in the ESCWA Region, 1997-1998* (United Nations Publication, forthcoming).

will not be strong, as Israel and Turkey, the two largest oil-importing economies of the region, continue their efforts to reform and stabilize their economies.

Oil exporters: falling revenues cut government spending

With the downturn of oil prices to levels reminiscent of those of the second half of the 1980s, Governments of the oil-exporting countries of the region are pondering how to cope with their sharply reduced oil income, the mainstay of their fiscal revenues and the main source of foreign currency. As a first reaction, a few Governments adopted measures to cut public expenditures, while others are considering means to generate more revenues for their budgets from other sources. For example, Saudi Arabia is reported to have temporarily frozen projects for which contracts have not yet been awarded.[20] Kuwait's Ministry of Finance has requested State entities to reduce expenditure by 25 per cent for the rest of the current fiscal year, which ends on 30 June 1998. Other oil-exporting countries, such as Bahrain, the United Arab Emirates and Yemen, also called for restraint in government spending. Nevertheless, for a number of oil-exporting countries in Western Asia (for example, Bahrain and Yemen), it is not easy to cut government expenditure because of the large component of wages and salaries for public sector workers.

Having earlier faced the prospects of lower oil revenues, the oil-exporting countries of the region initiated economic reforms over the past few years aimed at reducing spending and diversifying their economies through private investment. However, progress has been limited. Relatively low oil prices in most of the 1990s, combined with large military expenditures in the aftermath of the Gulf war and the rising costs of subsidies and welfare benefits, resulted in fiscal difficulties which required cuts in public spending in the countries of the Gulf Cooperation Council.[21] While selected subsidy cuts and price rises were introduced in a number of countries, including Saudi Arabia and the United Arab Emirates, most Governments of the region are still keen to shield the population from sudden price rises and are unlikely to eliminate subsidies or impose income taxes in the near future. The current economic downturn can be expected to increase the urgency of the fiscal reform and economic diversification strategy.

In the Islamic Republic of Iran, budgetary problems, large external debt obligations and a high rate of inflation will continue to constrain growth. The new Government is, however, improving economic relations with the Persian Gulf States, as well as with other countries. The Government aims at accelerating efforts to attract foreign direct investment and the investment climate is becoming considerably more accommodating. The Government will also aim to boost non-oil exports by easing foreign exchange restrictions so as to increase the availability of imported inputs for non-oil industries.

Steady growth in oil-importing countries

Average economic growth in 1997 remained above 5 per cent, despite a slowdown in Israel. The pace in 1998 is expected to decelerate slightly to about 4 per cent. Economic growth in Jordan was strong in 1997 (6.2 per cent) and is expected to be sustained in 1998 with assistance from abroad. Continuing liberalization of the economy should bolster business confidence and attract foreign investors. Remittances of Jordanians working abroad will continue to boost private consumption. Increased trade with Iraq and the Persian Gulf States will boost export growth, but investment will be constrained. In

[20] *Middle East Economic Digest*, 23 March 1998.

[21] The member countries of the Gulf Cooperation Council are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

Lebanon, GDP growth was moderate for the second year, averaging about 4 per cent in 1997, compared with 7.5 per cent annually between 1992 and 1995. The slowdown is expected to persist in 1998, partly as the result of high interest rates to support the exchange rate.

In **Israel**, economic growth fell sharply in 1997 after several years of strong growth. High domestic interest rates, and fiscal problems, as well as uncertainty over the peace process, contributed to the sluggish growth. The slowdown is expected to persist in 1998 as economic restructuring continues and as fiscal and monetary policies remain tight and receipts from tourism low. The economy in the **West Bank and Gaza** continued to suffer from high unemployment and from Israel's frequent closure of the Palestinian territories. Prospects for economic growth in 1988 remain highly dependent on the peace process and on the remittances of Palestinians working in Israel. The planned opening of the Gaza Industrial Estate in May 1998 should help improve the investment climate in the Palestinian territories.

Economic output in **Turkey** continued to expand at a rapid pace in 1997 (6.8 per cent), albeit with an inflation rate estimated at about 80 per cent. In 1998, growth is expected to moderate but remain above 5 per cent, with significant deceleration of inflation. The high growth since 1995 has been driven mainly by buoyant exports, strong recovery in private consumption and expansionary fiscal policies. The newly established coalition Government has pledged to implement a new stabilization programme aimed at lowering inflation to single digits in a period of three years. The stabilization programme includes measures to raise revenues and reduce subsidies. It also includes cancellation of investment projects and privatization of State-owned enterprises, including telecommunication and energy.

Latin America and the Caribbean: Asian contagion

The combination of relatively strong economic growth – per capita output rose about 3.6 per cent – and an average inflation rate of just over 10 per cent made 1997 one of the best years of the last two decades for the economies of Latin America and the Caribbean.[22] However, output growth is slowing significantly in 1998. This is partly the result of strong policy measures and partly the consequence of the contagion factor from the Asian currency crisis.

Sources and constraints on dynamism in 1997

Argentina, Chile, the Dominican Republic, Mexico and Peru led the region with 1997 rates of growth of GDP between 7 and 8.4 per cent. Uruguay was next at 6.5 per cent and most of the other economies grew by about 3 to 5 per cent. GDP in Haiti stagnated and Jamaica was the only economy that recorded a decline in output.

Supported by a generally favourable international environment during the first three quarters of the year, the expansion was driven by investment, which was especially strong in Argentina, Bolivia, Costa Rica, Dominican Republic, Mexico, Nicaragua and Venezuela. Renewed business confidence and progress in rehabilitating the banking sector led to an expansion in lending to finance new economic activity. Domestic consumption strengthened in the second half of 1997, especially in Argentina, Chile and Mexico, with stronger employment growth and wages. Growth was also underpinned by the continued buoyancy

[22] The discussion of 1997 economic trends in the region draws in part on *Preliminary Overview of the Economy of Latin America and the Caribbean, 1997* (United Nations publication, Sales No. E.97.II.G.13).

of exports across the region, expanding on average at twice the rate of increase of output. The main impetus for this buoyancy was intraregional trade which increased faster than total trade. Besides rising volumes, export earnings were boosted by favourable prices for some of the main export commodities, such as coffee, bananas (benefiting particularly Central America), beef, shrimp, aluminium and zinc.

In the Caribbean, the economy of Jamaica continued to contract. Failures in the financial sector, persistent weakness in the manufacturing sector and poor agricultural output due to bad weather and uncertainties over the banana export regime offset strong earnings from tourism and bauxite and alumina exports. Haiti's economy has been severely affected by an institutional crisis that has left the country without a functioning Government since June 1997, making it impossible to resolve uncertainties over economic policy. It also delayed the release of international aid, and disrupted budget allocations. Labour unrest further weakened the economy.

Serious drought in some areas and heavy rainfall in others caused by the El Niño phenomenon affected especially the Andean subregion in the second half of the year, but these occurrences were expected to ease in the first quarter of 1998. Peru bore the brunt of the damages in its fishing and agricultural sectors and, to a lesser extent, in processing of primary commodities, commerce and transportation, although strong growth was still attained for the year as a whole; Chile, Colombia, Ecuador and Guyana also suffered from drought or floods. The damage has prompted a boom in construction, as in Peru and Ecuador houses are rebuilt and roads and bridges repaired.

The average inflation rate in the region in 1997 reached its lowest level in half a century, and over half of the countries achieved single-digit price increases (see table A.13). Tight monetary policies, the strong dollar – holding down import prices in countries whose currencies are tied to it – and faster productivity growth in the wake of strong investment spending, contributed to the decline. Inflation reduction has been remarkable in three countries that use the exchange rate as an anchor for prices, namely Argentina, Brazil and El Salvador. In Brazil, inflation reached the lowest level in decades, owing to the economic slowdown and the elimination of wage indexation. In El Salvador, it dropped from 7.4 per cent to under 2 per cent. Even Mexico and Venezuela, which had recently suffered outbreaks in inflation, made substantial progress. Inflation increased in only four countries (Barbados, the Dominican Republic, Ecuador and Haiti), although in two of them (Barbados and the Dominican Republic) it remained under 10 per cent.

After a gradual reduction in fiscal deficit in recent years, the pattern was mixed in 1997, with some countries increasing public spending after prolonged austerity (Mexico and Peru) or owing to non-discretionary transfers to reformed pension and social security systems (Argentina and Uruguay). In Brazil, the 1997 budget deficit (excluding revenues from privatization) rose to almost $50 billion, or 6.1 per cent of GDP, as a result of rising social security outlays and increased spending by the States, which has been financed by large privatization receipts.

External conditions worsen by year-end

Since the third quarter of 1997, the spreading and deepening of the Asian crisis has led to a drastic deterioration of the external environment in the region. The first effect was a tightening of external financing conditions, with higher risk premiums' raising interest rates and shortening maturities for borrowers in international markets. Borrowing conditions have improved only partially since last October, with foreign lenders still requiring higher spreads for the perceived higher risks of many emerging markets. Capital flows to the region, however, appeared to be recovering in early 1998, enticed by higher

interest rates and new investment opportunities created by new government privatizations. Capital inflows have been such as to have raised Brazil's foreign reserves to a historic record of $64 billion by the end of March 1998, some $14 billion above the low point during the fall speculative attack. At this time, fears of a capital shortage have diminished.

The fallout from the Asian crisis has also become apparent in the trade area. Real effective exchange rates in the region have appreciated relative to those of some Asian competitors, and exports to Asian markets are experiencing slower growth. With Asian demand reduced considerably (including that of Japan), commodity prices have dropped. Oil and copper prices have weakened the most, hitting especially Venezuela, where oil represents about three quarters of merchandise exports, and Chile, where copper accounts for about 40 per cent of total exports. Ecuador and Colombia, dependent on oil for some 29 per cent and 23 per cent of exports, respectively, and Peru, with nearly 20 per cent of export revenues from copper, are also being affected.

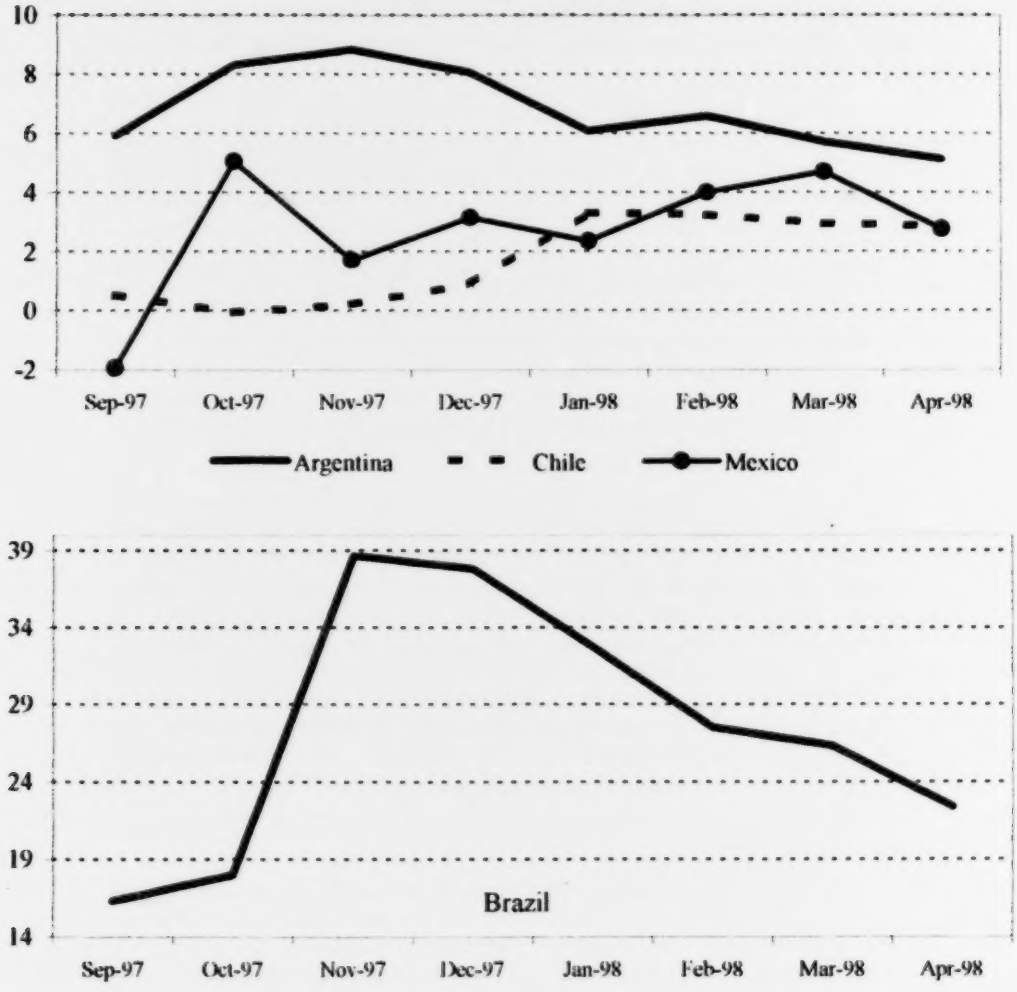
The impact will be less in Mexico, where oil, once its key export product, currently accounts for only about 10 per cent of its foreign sales. The impact will also be less in Argentina, although it will be hurt by lower prices for grains. Mexico, the largest exporter of manufactures in the region, is the country most at risk of losing competitiveness vis-à-vis Asian exports. The slower growth forecast for the United States (see above) might further dampen its demand for Mexican exports. Central American countries, especially El Salvador, Guatemala and Honduras, which are processing centres for textile exports, will similarly face increased competitive pressures. Finally, although Latin American trade with Asia is limited, accounting for less than 10 per cent of total exports and some 14 per cent of imports, the higher exposure of Chile, Peru and Brazil (contributing one third, one fourth and some 16 per cent of the total, respectively) puts their export sectors in a less favourable position.

Quick and effective policy response

The policy response to the changed international environment has been swift. Several countries have taken steps to contain macroeconomic imbalances, as international investors have become particularly sensitive to the growth of fiscal and, even more, current account deficits. The Brazilian Government, faced with a strong speculative attack against its currency in October 1997, virtually doubled interest rates (see figure II.3). They were already among the highest in the world in real terms and their increase makes local currency assets relatively more attractive, helping to defend the exchange rate, the core of Brazil's anti-inflationary policy. The Brazilian Government also announced fiscal expenditure cuts of over 2 per cent of GDP and used the crisis as an opportunity to deepen fiscal reforms, as the Brazilian Congress stepped up efforts to strengthen public finances by passing legislation on civil service and social security which had been held up for nearly three years.

Figure II.3. Real short-term interest rates in selected Latin America countries, September 1997 - April 1998 [a]

(Annual percentage rate)



Source: J. P. Morgan & Company, New York.

[a] Argentina: 7-day call money; Brazil: overnight interbank; Chile: central bank readjustable paper (PRBC) rate; Mexico: 28-day Treasury bill. All deflated by consumer price index.

In addition, in November 1997 the Government reduced the minimum maturity of foreign loans and bonds issued by Brazilian entities to one year from three. Later, it came to be expected that the minimum maturity would be raised, prompting a rush in financing to take advantage of the less restrictive controls. Indeed, on 26 February 1998, the Central Bank increased the minimum maturity to two years. Then, at the end of March, the Government partially closed a loophole allowing banks to borrow funds abroad and invest them in dollar-indexed Brazilian bonds at much higher interest rates, thus further restricting short-term inflows.

Other countries, including Chile, Ecuador, Mexico and Venezuela have adopted a varied set of monetary and fiscal measures. Mexico and Venezuela, where oil is a main source of fiscal revenues (over a third and nearly 60 per cent, respectively), announced spending cuts and let their currencies adjust to the deteriorated terms of trade. In Venezuela, and to a greater degree in Chile, interest rates have been raised to limit the depreciation of their currencies, cool off domestic demand and keep inflation in check, this with an eye as well to limiting the external deficit. The Government of Ecuador, counting on oil for nearly half of its fiscal revenues, was unable to convince its Congress to adopt a substantial increase in the VAT (from 10 to 14 per cent) or accelerate the privatization of its State telecommunications company so as to counter the sharp drop in revenues. It therefore resorted to a devaluation of its currency (also aimed at addressing the deteriorating external balance) and to small fiscal adjustments.

Furthermore, because of the reform measures adopted during the 1990s, the region was in a stronger position to withstand the Asian shock than it had been at the time of the Mexican crisis of 1994-1995; that is to say, since the serious bank crises in Chile in 1982, in Venezuela in 1994 and in Mexico in 1995, the authorities have tightened regulations, while banks have made improvements in their risk management. Argentina and Brazil have also taken steps to overcome weakness in their financial systems through programmes to restructure and strengthen financial institutions, and measures to increase minimum reserve requirements so as to build up liquidity and tighten capital adequacy standards, as well as by arranging standby agreements with foreign banks for emergency liquidity. Considerable banking system reforms were also undertaken in Mexico at a cost that has risen to 14.5 per cent of GDP; nevertheless, bad loans still stand at about 13 per cent of the total there, a level from which it will likely take several years to recover.

1998 economic outlook

The combination of weaker external conditions associated with the Asian crisis and policy measures in response, as noted above, and, in a few countries, a retreat from an unsustainable rate of expansion, will result in a deceleration in Latin America's economic growth in 1998 to about 3.3 per cent. The austere fiscal and monetary measures taken by Brazil, the region's largest economy, will limit its growth to about 1 per cent. High, though gradually declining, interest rates will dampen investment and consumption. A high price for the defence of the exchange rate is being paid in terms of growing unemployment which, at 7.4 per cent in February 1998, reached a 14-year high. Venezuela's growth prospects have been seriously weakened by the sharp drop in the price of oil and the economy is unlikely to expand over 1 per cent.

Four of the fastest growing economies in 1997 (Argentina, Mexico, Peru and Chile) will also experience a significant deceleration. Argentina, still expanding briskly in the first quarter, thanks to robust investment and rising consumption, will see a deceleration of its rate of growth largely as a knock-on effect of the slowdown in Brazil, which buys almost a third of its exports, as well as of higher interest rates and lower prices for its

exports. Mexico is enduring budgetary cuts and lower oil prices, but will move to more sustainable growth based on stronger private consumption and robust foreign investment, partly offsetting a slower expansion of exports. Peru, in turn, will continue to be damaged by the combined effects of El Niño and the Asian fallout, which is also hitting Chile, through the widening of its external imbalance. Most countries in the region will sustain rates of growth of 3 to 5 per cent.

Central America's performance will be affected, particularly in Honduras and El Salvador, by the most severe drought so far this decade, which is already causing large losses in the farming sector and power supply, 70 per cent of which is dependent on hydroelectric sources. However, sustained foreign investment, particularly in the power, technology and telecommunications industries, and improving business confidence should support a moderate expansion. Economic prospects in Nicaragua should benefit from the prospect of an injection of $1.8 billion in international aid, pledged in March 1998, over a three-year period.

Regarding fiscal balance, in Brazil the benefits of the aforementioned $17 billion emergency package will be partly offset by higher interest payments and the fiscal pressures of an electoral year. In Argentina, lower revenues as a result of the economic slowdown might lead to a postponement of planned infrastructure projects and an early implementation of tax-raising measures. Ecuador will experience a difficult year for public finances, as the Government faces a hefty repair bill for the extensive damage to housing and infrastructure caused by El Niño and increased expenditures coming from pay rises awarded to public sector employees in 1997. Meanwhile, fiscal revenues will be hit by lower international oil prices and a set of fiscal measures to offset these effects is unlikely to prevent the public sector deficit from widening to about 4 per cent of GDP this year.

Latin America's external accounts are once again one of its most vulnerable areas (see chap. III). Large or rising external imbalances in several countries, including Argentina, Chile, Colombia, Ecuador and Peru, represent a major constraint on sustained growth, as they force corrective measures that often reduce the pace of economic expansion.

Finally, the "social deficit" of unemployment, poverty and inequality, which appears to have improved slightly in 1997, may well worsen again in 1998. The improvement in 1997 could be attributed to the strong growth in some countries. Thus unemployment dropped in Argentina and Mexico, but picked up slightly in Brazil, Colombia and Uruguay, owing to a reduction in manufacturing employment. In 1998, tightening fiscal and monetary policies and the expected economic slowdown could lead to higher unemployment in the region. This trend is already evident in Brazil. In turn, a deteriorating social situation might weigh on the future of current tight policies, especially in countries undergoing major elections in the months ahead. Moreover, the earnings gap between skilled and unskilled workers in the region remains the largest in the world and is greatest in Peru (30 per cent), Mexico (25 per cent) and Colombia (20 per cent); indeed, in this decade, the earnings of the region's skilled workers have been increasing annually at a rate at least three percentage points higher than those of the unskilled.[23]

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[23] See *The Equity Gap: Latin America, the Caribbean and the Social Summit* (United Nations publication, Sales No. E.97.II.G.11), chap. II, sect. entitled "Labour income disparities".